STRATEGIES AND STRUCTURES FOR INSTITUTIONAL
REAL ESTATE INVESTORS WITH TROUBLED ASSETS

by

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ABSTRACT:

From the boom of the 1980’s to the crash of the 90’s, fundamental changes have occurred in the real estate industry. The banking industry was the first to be thrown into a tailspin and future generations of taxpayers will be bear the cost of funding the government bailout of the savings and loan industry. Many insurance companies, investment banking houses and pension funds are reeling with similar trouble, but these institutional real estate investors will be left to their own devices to deal with their troubled loans and equity assets.

The emphasis now is on workouts and asset management rather than new business. To effectively meet the challenges presented in the current volatile real estate environment, firms must be able to effectively redeploy their skills and resources. This thesis outlines strategic and structural considerations that these institutional investment firms must face as they adapt to the changes that have occurred in the real estate market. Current assessments of the institutional real estate investment community and of the life insurance industry’s investment in real estate are included as background material.

A discussion of organizational learning, structure and obstacles to change precede an examination of two firms from the insurance industry that have experienced different amounts of real estate trouble in their respective portfolios. Equitable Real Estate Investment Management Inc. and the Travelers Realty Investment Company are analyzed against a framework for organizational structure and organizational learning to assess each firm’s ability to manage the process of change.

A comparative analysis of each firms’ strategy and structure is presented in the last chapter and the thesis concludes with a brief list of recommendations that are applicable to all institutional real estate investors:
• Institutional real estate investors should be more proactive in how they approach organizational change;
• They need to give their employees the ability to participate in a regular planning process;
• They need to expect a healthy level of failure; and
• They should make higher-order organizational learning a strategic priority.

Thesis Supervisor: Gloria Schuck
Title: Lecturer, Department of Urban Studies and Planning
It seems fitting that much of this thesis is about learning and change since these are the words that best describe my experience over the last several months. I am grateful to each of the individuals at the Boston offices of Equitable Real Estate Investment Management Inc. and the Travelers Realty Investment Company who gave so freely of their time. Special thanks go to the head of Equitable Real Estate’s office and to one particular investment manager at Travelers Realty (both of whom I would name if I could).

Special thanks go to Gloria Schuck, my thesis advisor, for challenging me, for being patient, and for helping me to craft a better research document. Thanks for being a good teacher.

I am most appreciative for the warmth and caring of my parents, my two brothers, and some incredible friends. Thanks Mom, Dad, Danny, Gary and Picks for your advice, support and your high tolerance for long-distance grumbling. As always, there’s a piece of you in here.
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CHAPTER ONE

BACKGROUND AND DEFINITION OF THE PROBLEM:

The time to be a real estate developer was in the early and mid-1980’s. Capital was plentiful, loans were easy to obtain and most major markets were booming. The deregulation of the banking industry--combined with other trends in interests rates and asset securitization--opened the floodgates for real estate loans and equity investments. Institutional lenders and investors jumped on a bandwagon that poured hundreds of billions of dollars of new capital into the real estate development business. This money, however, was too abundant and the capital often flowed indiscriminately into inflated, marginally viable real estate deals.

Investments were made with little sophisticated consideration of the market viability of the underlying assets; deals were done and money was exchanged at times simply to generate transactions that produced fees for both lenders and developers. The intangible financial aspects of the real estate development business overwhelmed the bricks and mortar reality of construction and market demand. Savings and loans, investment banks, insurance companies and pension funds poured capital into the real estate development industry as lenders and investors saw the potential for returns that exceeded all other types of investments. Pension funds, for instance, expecting yields in excess of 13% provided about $50 billion in new capital to the real estate industry from 1980 to 1985.1 Another $50 billion was invested by the pension funds from 1985 to 1990 even though expected yields dropped to 10.2% during this time.2 The total estimated $100 billion that the pensions now have invested in real estate, while only about three percent to five percent of their total assets, still represents a potentially huge liability.

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1 Hemmerick, Steve, "Real estate may drop 15% more," Pensions & Investments, April 27, 1992, p.35.
2 Ibid.
During the boom of the 1980's, however, it was possible to make money in real estate “development” without actually building anything or producing an income-generating project. Loans were made and projects were built—many on sheer speculation—merely for the sake of generating the associated transaction fees. Lenders and investors, realizing that there were profits to be made simply by doing such transactions, viewed the seemingly ever-expanding real estate markets of the mid-1980’s as license to push money out the door:

...whenever investors are swamped with funds and are rewarded for placing them, they will keep on placing them regardless of the prudence of the deals involved. ...If lending officers swamped with money can't make good deals, they will make bad ones; if they can't make bad ones, they will make terrible ones; if they can't make terrible ones, they will make horrible ones—but they will make deals. 3

The opportunity to acquire capital and build was enticing to anyone who ever dreamed of becoming a real estate developer—competence was not a prerequisite. Anecdotal stories abound that tell of how the continued climb in prices and rental rates compensated for the most egregious business errors. Real estate development appeared to be a no-lose proposition.

When the institutions ran short of capital to lend, they boosted their cash flow by issuing bonds and guaranteed investment contracts (GICs) that paid high interest rates, but allowed lenders to raise the desired additional capital. This additional capital was then loaned or invested in real estate deals that promised to earn even higher returns—and associated fees. The interest rates paid on these GICs and other similar corporate obligations were partially a reflection of the issuing company’s investor credit rating. During the boom years, reported yields and profits kept most institutional real estate investors’ credit ratings high.

Capital, therefore, was easy to raise and the gold rush of lending and investing continued in high gear. Those in the banking and real estate development industry that warned of over-financing and impending doom were drowned out by the din of money changing hands. Real estate developers and institutional investors continued to leverage their long-term futures for short-term gains and an artificial inflationary bubble was created that sent real estate prices and rental rates to new heights. By the late 1980’s, however, most markets were overbuilt and most institutional lenders, investors and developers were overexposed. The infrastructure supporting unprecedented growth in the real estate capital markets was dangerously thin.

Then the economy stumbled.

The stock market crashed in October 1987 signaling that serious problems in the general economy and capital markets were already afoot; the climb in real estate prices and rental rates slowed, stalled or started to fall; and real estate values across the board began a precipitous drop:

...investors are not always swayed by objective evidence—even overwhelming evidence if it leads to conclusions that contradict their immediate interests as perceived by the “herd.” Evidence of overbuilding in office and other markets was overwhelming by 1987, and probably even earlier. By 1987, the national office-space vacancy rate—which was under 5% in 1981—had exceeded 19% for three years running. Yet banks accelerated their investments in new construction loans in 1988 and 1989. Even long-term investors continued to buy real estate at rather high prices, although effective rents were falling sharply.4

As the markets continued to soften in the late 1980’s, marginal projects couldn’t produce enough income to meet their debt-service. Many projects that were built on speculation remained virtually empty. Real estate prices and rental rates fell even further as a national recession settled over the country, the Gulf War ensued, and market demand

4 Ibid.
began a spiraling descent. In some places the fall was slow but steady; in others, markets went into relative freefall.

What began as a trickle of troubled real estate loans and investments soon became a deluge. The amount of asset-based loan defaults began to overwhelm the banking industry, particularly the savings and loans. As the trouble mounted, lenders faced ever-increasing numbers of defaults and foreclosures that swelled REO (real estate owned) portfolios and threatened the solvency of many institutions. Under the weight of too many bad real estate loans, many thrifts failed. The Resolution Trust Corporation (RTC) was formed in 1989 to help bailout the savings and loan industry as an unprecedented number of thrifts became insolvent. The banking industry, however, represented just the tip of the iceberg. Insurance companies and pension funds scrambled to find ways to deal with their troubled loans and assets. And a new business was born—workouts.

• CURRENT STATE OF THE INSTITUTIONAL REAL ESTATE INVESTMENT INDUSTRY:

The banking industry--starting with the savings and loans--was the first to experience widespread real estate lending and investment related troubles with pension funds and insurance companies not far behind. While it seems common knowledge that the scale of the problems is enormous, quantifying the potential liability for institutional real estate investors is difficult. This section of the thesis presents current data on the banking, insurance and pension sectors to piece together a current assessment of the size and scope of the institutional real estate community’s problems. Where possible, specific data relating to the Travelers Insurance Company and Equitable Life Assurance Society of the U.S. is used to represent industry trends. (These two companies will be examined in greater detail in later portions of this thesis.)

The numbers typically used to report on current industry conditions are staggering, usually in the millions, billions and trillions of dollars. For instance, a 1992 article in The Wall Street Journal pointed out a sizable discrepancy in the estimated total
cost of the thrift industry bailout by the Resolution Trust Corporation. Albert Casey, the CEO of the RTC, said in May, 1992 that the cost of rescuing the savings and loans probably will not exceed an estimated $130 billion. The Wall Street Journal, however, pointed out that a more complete analysis has been done by banking consultant Alex Sheshunoff of Austin, Texas. His analysis not only included costs since 1985 (the RTC only included bailout costs from 1988 on), but added the interest expenses on the bailout funding, as well as costs relating to higher deposit insurance premiums. Sheshunoff estimated that the total taxpayer expense will amount to $2.34 trillion by the year 2019. (In constant 1990 dollars, assuming 4.5% inflation, that amounts to $1.12 trillion.) This is one of the first published estimates that may provide a more realistic picture of the total costs--many hidden in the political bureaucracy--of the thrift industry bailout.

Similar signs of mounting distress come from the Federal Deposit Insurance Corporation (FDIC) which said its reserves for losses at banks that are expected to fail had been doubled for the 1991 fiscal year to $15.4 billion. This loss reserve, however, is merely a reflection of federal funding allotments as voted by Congress. A more realistic assessment provided by the FDIC's 1991 year-end annual financial disclosures was given in the following report:

> Although the number of problem banks rose only slightly to 1,090 in 1991 from 1,046 in 1990, total assets at these banks soared to $609.8 billion from $408.7 billion. Assets from failed banks held for liquidation nearly doubled to $34.4 billion from $18 billion.

> Although the FDIC handled fewer bank failures in 1991, the average asset size was more than five times the average in 1990. The FDIC said 168 banks failed in 1990, with average total assets of $14.7

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6 Ibid.
7 Ibid.
8 Ibid.
billion. In 1991 the FDIC seized 124 failed banks, with record average assets of $63.1 billion.\textsuperscript{10}

Each successive year brings reports of new records in total insolvencies, losses, and needed reserves.

The total cleanup costs for the banking industry continue to climb day by day as political inexpediency and a depressed U.S. economy delay efforts to quickly resolve the problems. One can only extrapolate from piecemeal information found imbedded in related industry reports to estimate the potential total costs of these delays. A recent article reported, for instance, that 40 insolvent savings and loans are due for government seizure but can’t be sold or liquidated until congress passes another funding bill for the thrift industry bailout.\textsuperscript{11} “In the meantime, they continue to accumulate losses of $1 million to $2.5 million a day that eventually will be borne by taxpayers.”\textsuperscript{12} Time, therefore, is a precious commodity as even relatively short delays can add millions of dollars to losses and eventual cleanup costs. Taken in the aggregate, these delays only inflate the nearly incomprehensible proportions of the losses eventually to be borne by taxpayers.

The problems and costly delays, however, are not merely isolated to the banking industry. Pension funds and insurance companies are left, without any government safety-net or taxpayer financed rescue effort, to deal with their own real estate related troubles.

A group of 24 life insurance companies was surveyed by the Mortgage Bankers Association to assess the value of their loans currently tied up in bankruptcy court proceedings (a strategy often employed by borrowers to buy more time with a lender). This group of commercial real estate lenders reported that the value of their loans tied up

\textsuperscript{10} Ibid.
\textsuperscript{12} Ibid.
in bankruptcy doubled in 1991 from the previous year to $1.17 billion. As the U.S. legal system gets clogged with an unprecedented number of bankruptcy filings, the delays—and costs—mount. These 24 companies, which hold only about $80 billion in commercial real estate mortgages, provide just a glimpse into the scope of the problems affecting the insurance industry. Yet this group said that bankruptcy-law filings made in 1991 alone accounted for $993.6 million of the loans tied up under Chapter 11 filings, more than double the $452.5 million in loans that were part of new bankruptcy cases in 1990. As these trends indicate, borrowers may be getting either more savvy or more desperate. Delays mean additional losses and higher costs. Lenders have begun to recognize the value of more expedient and cooperative ways to approach trouble assets and loan defaults. These lenders are also lobbying Congress to alter the existing U.S. Bankruptcy Code to reduce the number of single asset borrower defaults that can be protected under Chapter 11 bankruptcy filings in a move to stem the costly delay tactic from being employed as often.

The effects of the real estate lending and investment related problems are often reported in the aggregate, as indicators of industry performance or general economic trends. The impact on individual institutional investors, however, has also been enormous. The Travelers Insurance Company, whose real estate related problems run deep, serves as an example of what is going on in the industry. Travelers, for instance, halved its 1991 net income to $318 million because of losses on real estate. As a diversified investment company, Travelers’ problems can spread to other asset classes and industries. Individual insurance policyholders may even be affected as Travelers’ liquidity, investment ratings and solvency are called into question. With an estimated

14 Ibid.
15 Ibid.
$15 billion invested in real estate, Travelers currently has about 36% of its portfolio classified as underperforming.\(^\text{17}\) Citing the company’s real estate troubles, Moody’s Investor Service Inc. and Standard & Poors Corp. both recently downgraded Travelers’ financial strength rating to Baa-1 from A-2 (a two notch drop). Travelers’ rating is now lower than all but a handful of the nation’s largest life insurance companies tracked by the investment ratings services.\(^\text{18}\) The effect is to force Travelers to pay higher interest rates on money that it borrows (sometimes in the form of GICs or other corporate securities) to stay liquid. “Based on our understanding of their current capital raising efforts and based on their real-estate portfolio, we felt the downgrading was necessary,” said Chester Murray, associate director with Moody’s.\(^\text{19}\) Industry sources now believe, however, that Travelers might be facing a liquidity squeeze, largely because of efforts to support its problem real estate and its lowered credit rating.\(^\text{20}\) According to an investment banking firm analyst, even prior to its credit rating being lowered to Baa-1 by Moody’s and Standard & Poors, Travelers had to offer substantial interest premiums in order to place $300 million in 10-year senior notes during the first quarter of 1992. These notes were sold to yield 9.5%, more than 200 basis points over the 10-year Treasury note.\(^\text{21}\) “Travelers was hoping to sell these notes priced at only 175 basis points over, but had to extend that in order to get them sold,” the analyst said. “That means that they were very anxious to place them at practically any cost in order to get the funding.”\(^\text{22}\)

“If you paid $50 million for some real estate five years ago expecting to pay it off…and now GICs are not being reinvested and your mortgage loan is not paying off through foreclosure or default…you have

\(^{17}\) Ibid.
\(^{18}\) Ibid.
\(^{19}\) Ibid.
\(^{21}\) Ibid.
\(^{22}\) Ibid.
a liquidity crunch. In a normal market [Travelers] would just go out and issue more GICs to receive funding, but now no one is buying them.”23

Despite the spate of recent bad news, Travelers may have a lead within the insurance industry in confronting its real estate related troubles; it recognized and admitted to its problems relatively early. Many other insurance companies may be in similar, albeit less conspicuous, situations.

If guaranteed investment contract business is any indicator of an insurance company’s real estate related troubles, it is telling that both Equitable Life and Aetna Life lost more GIC business in 1991 than Travelers. Equitable lost $3.135 billion in GIC business while Aetna lost $1.454 billion, compared to Travelers 1991 loss of $1.361 billion.24

All three had been among the industry’s leaders in new GIC business. Now they have mounting financial woes linked to the same problems that prompted [pension] plan sponsors to flee from GICs: deteriorating credit quality caused largely by underperforming mortgage loans and problem real estate.25

Recent reports such as these are an ominous fact of life for both the insurance industry and institutional investment community as a whole. Pension funds, for instance, frequently rely on individual insurance companies to manage their real estate loans and equity investments. The real estate troubles reported in the insurance industry have a direct link and impact on the pensions. It becomes more understandable, therefore, why four times as many pension executives, when recently polled, said they planned to terminate their current real estate investment manager.26 (35 pension plans said they

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23 Ibid., Quote attributed to “another financial analyst.”
24 Ibid.
25 Ibid.
26 Hemmerick, Steve, “Real estate may drop 15% more,” Pensions & Investments, April 27, 1992, p.35.
dropped a real estate investment adviser in 1991, but 120 pension plans said they
anticipated dropping a real estate investment manager in 1992.)

Pension funds obviously have their own industry-wide real estate troubles to
contend with. SEI Capital Resources, a firm that tracks a group of 65 real estate funds,
reported a record low one-year performance of -8.6% median total return for 1991. (The
previous record low of +2.2% was set in 1990.) SEI Capital Resources also
reported that trophy class real estate assets—the properties the pension funds expected to
help mitigate the effects of overall falling real estate investment performance—
experienced the largest drop, down 8.3% in returns.

All property types have been experiencing a substantial loss in value in the past
few years leaving virtually all pension funds with problem assets, despite the focus or
diversification of real estate held in a particular fund’s portfolios. Consider the following
three reports, each representing a different type of portfolio property investment:

- JMB Institutional Realty Corp., Chicago, reported its Group Trust IV
  fund had 4.6% in income but a 25.2% depreciation in value for a total
  return of -20.6% for the year ended Dec. 31, 1991. The fund invests
  primarily in retail malls and first-class offices.

- CIGNA Investments Inc.’s Separate Account R reported income of 6.7%
  but depreciation of 16.1% for a total return of -9.4% for the year ended

- The LaSalle Street Fund of LaSalle Advisors Ltd., Chicago, reported an
  income return of 5.86% but depreciation of 18.25% for a total return of
  -12.39% for the year. The fund invests primarily in premier office
  properties.

27 Ibid.
28 SEI Capital Resources, Wayne, PA.
29 Hemmerick, Steve, “’91 Real Estate Returns Plunge to Record Lows,” Pensions & Investments,
30 Ibid.
31 Ibid., emphasis added.
On the whole, pension fund real estate portfolios lost 10% to 15% of their value, excluding income, in 1991 alone. According to Thomas Mahoney, a managing director at CIGNA Investments, 1991 represented “pretty much a freefall” in real estate performance. He said real estate managers hope the market is bottoming out, but added “there is no way to really know.”32 While the numbers are still coming in, recent reports indicate that 1992 may be the worst year yet for pension funds since they began investing in real estate. The 1992 year-end Russell-NCREIF Property Index could hit -4.5%, according to predictions by the real estate research department of Salomon Brothers Inc., New York. This would be 550 basis points below the previous Russell-NCREIF Property Index record low of 1.2% for calendar 1990.33 Pension fund real estate portfolios may lose an additional 15% to 20% in value in 1992, according to current industry predictions, amounting to another $15 billion to $20 billion loss for the pension funds.34

Even with these writedowns by pension funds, many portfolios are still overvalued. A Salomon Brothers survey recently revealed that real estate money managers said they would not pay the high prices they have placed on the overall value of their own portfolios. The survey showed a 330 basis point spread between the bid and ask price for real estate.35 (A 50 to 70 point spread is considered normal.)

• SUMMARY:

Overvaluation, lagging performance and dismal returns are the symptoms of an ailing real estate industry. Pension funds, insurance companies and other institutional investors will be dealing with their troubled loans and investments for years to come. A government bailout--particularly one on the scale of the effort and expense being used to rescue the savings and loan industry--is improbable. Institutional investors will have to

32 Ibid.
33 Ibid.
35 Ibid.
use their own financial and human resources to meet the challenges now before them. If the challenge of the 80's was how to make the most real estate loans and investments, the challenge of the 90’s is how to most effectively deal with troubled assets. Institutional investors are making strategic and structural changes to adapt to the instability in the external markets.

This thesis will examine whether institutional investors, particularly insurance companies, are using organizational restructuring as an effective intervention strategy to acquire new skills or redeploy resources. To what extent are market forces requiring institutional investors to become better learners? Are institutional investors spending more of their time, money and human resources on working out their real estate problems rather than focusing on making new loans or equity investments? Have they reorganized their corporate task systems around those functional skills that are now needed most? Is there an increased need for organizational collaboration, cooperation, learning and change? These are some of the questions that this thesis will address.

**THESIS OUTLINE:**

This thesis will explore how institutional real estate investors can adapt to the changes that are occurring in a highly dynamic real estate market. It will identify the types of structural and strategic changes that institutional investors are making within their own organizations and will highlight areas of concern for those organizations actively considering ways to make more effective use of their resources.

“Organizational learning” is a body of management-related literature that deals with how organizations learn in order to have the ability to continuously adapt to change. A discussion of key “organizational learning” concepts is presented in Chapter Two. Adaptation and change comes to institutional investors in the form of organizational restructuring. Outlines of organizational structure and organizational obstacles to change round out the academic framework presented in the second chapter. Chapter Three
presents data collected from two institutional real estate investors from the insurance industry--Equitable Real Estate Management Inc. and the Travelers Realty Investment Company--that are actively involved in managing large portfolios of loans and assets, but are experiencing different amounts of real estate related troubles. The final chapter of this thesis includes a comparative analysis of the two firms and presents general conclusions to guide those institutional real estate investors concerned with using there organizational resources more effectively,
CHAPTER TWO

- ACADEMIC FRAMEWORK:

As described in the first chapter, the magnitude of the real estate trouble is astounding with costs and losses routinely counted in the billions and trillions of dollars. The stakes, therefore, are enormous as organizations work to cope with difficult markets and portfolios of troubled loans and assets. With increasing commercial vacancy rates, falling property values across virtually all product types, and severe capital illiquidity, the real estate industry is challenged by what one might euphemistically call extraordinary change. These changes have been swift, numerous and frequent enough to create fundamental shifts in the industry, shifts that will be with us even after we settle into a more promising part of an economic cycle.

Institutional real estate investors are now faced with the challenge of coping with this extraordinary change. Firms must learn to adapt as external market forces mandate internal organizational change. The acquisition of new skills or a redeployment of existing resources may help these companies adapt, survive and even prosper. But what kinds of changes are needed and what criteria should serve as a guide? The academic foundation for this inquiry is presented in this chapter.

- ORGANIZATIONAL LEARNING:

“Organizational learning” is a body of management literature that directly addresses issues relating to how organizations develop competency to handle change. Individual and organizational learning, therefore, serves as a foundation on which to build an inquiry into organizational change. Organizations must be able to deal with change at one of three competence levels. At a bare minimum, firms need the ability to change to survive during periods of extreme externally imposed pressures. Research concludes that most companies chose to maintain a sense of “internal consistency” within the structure of their

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operations rather than make the effort to continuously adapt to their environment over time.\(^2\) This means that these companies:

\[
...\text{maintain internal consistency at the expense of gradually worsening fit with [their] environment, at least until the fit becomes so bad that [they] must undergo sudden structural redesign to achieve a newly internally consistent configuration. In other words, the choice is between evolution and revolution, between perpetual mild adaptation, which favors external fit over time, and infrequent major realignment, which favors consistency over time.}\(^3\)
\]

This kind of crisis management in response to extreme organizational stress usually means that change occurs sporadically, in quantum leaps. These firms value internal consistency, particularly when markets become highly unstable and unpredictable; they will put up with brief periods of severe disruption to realign fit occasionally. This is a learning process that Daniel Miller calls the "quantum" theory of structural change.\(^4\)

Firms, however, that exhibit greater competence in managing change are ones that attain a higher level of organizational learning; this allows companies to effectively manage change on a more continuous basis. These firms opt more for evolution and continuous adaptation. They strive to keep up with unpredictable or unstable environments and are willing to live with more internally perceived risk and inconsistency.\(^5\)

But why should a firm choose to continue to build its competence level beyond that necessitated by changes occurring in the external environment? Why do some firms seek more than internal consistency and stability in their way of doing things? Argyris and Schön have said that the learning process itself, once started, can make us aware of a new reality that demands this type of continuous, evolutionary response:


...We begin to suspect that there is no stable state awaiting us over the horizon. On the contrary, our very power to solve problems seems to multiply problems. As a result, our organizations live in economic, political, and technological environments which are predictably unstable. The requirement for organizational learning is not an occasional, sporadic phenomenon, but is continuous and endemic to our society.  

Given this perspective, it becomes understandable why some organizations strive for more, why once started, some firms come to value evolution and learning as a way of life and will structure themselves accordingly to reap the benefits of their learning ability.

At the highest competence level, therefore, are those organizations that actively seek and promote continuous change. These organizations highly value the process of change and have structured themselves to facilitate learning, collaboration and innovation. These firms, known as "learning organizations," serve as the paradigm for organizational learning. They view change and learning as inextricable elements of the business environment. Learning organizations often give higher value and priority to such concepts as "creativity," "innovation," and "the management of change." They deliberately develop their learning ability as a strategic advantage, often to pursue emerging opportunities or acquire greater competency to outperform their competition. Learning organizations, therefore, exhibit the highest level of competence in dealing with change and are able to exploit this ability to their competitive advantage.

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7 Ibid., p. 26
8 Ibid.
• WHAT IS AN ORGANIZATION?

While we often speak of organizations as if they were sentient entities capable of making choices, gathering experience, and learning, these are activities carried out by individuals within the organization itself. Individuals within the organization function as an organic network that, in their collectivity, serve as agents for organizational action, particularly organizational learning:9

*It is true that we do apply to organizations many of the terms we also apply to individuals. We speak of organizational action and organizational behavior. We speak also of organizational intelligence and memory. We say that organizations learn, or fail to learn. Nevertheless, a closer examination of these ways of speaking suggests that such terms are metaphors. Organizations do not literally remember, think, or learn.*10

Using a cognitive metaphor, individuals interact and communicate by making synaptic connections that allow an organization, operating as a networked collectivity, to carry out its functions. Individual learning allows for new connections to be made which, in turn, allows for greater cognitive abilities at the organizational level. Individuals, therefore, serve as agents for organizational action and learning. Yet, there is a difference between a group of individuals and an organization. Left to their own devices individuals may work together, but may not be an “organization”:

...The mob is a collectivity. *It is a collection of people who may run, shout, and mill about together. But it is a collectivity which cannot make a decision or take an action in its own name, and its boundaries are vague and diffuse.*11

The very word “organization” holds the key to how a group becomes more than merely a collection of individuals. In an organization, there is an order to what otherwise might be anarchy and chaos. This order comes in the form of three conditions that are sufficient to make a “mob” of individuals into an organization:

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9 Ibid., p. 19.
10 Ibid., p.11.
11 Ibid., p. 13.
1.) An organization must be able to make decisions in the name of the collectivity;

2.) It must be able to delegate to individuals the authority to act for the collectivity; and

3.) It must have the capability of establishing boundaries between itself and the rest of the world.\textsuperscript{12}

Each of these three criteria is contingent upon the overlay of order and structure on the collection of individuals so that they may act and identify themselves as an organization. As Argyris and Sch\oen have said, "A collection of individuals organizes when its members develop rules for collective decision, delegation and membership. In their rule-governed behavior, they act for the collectivity in ways that reflect a task system."\textsuperscript{13} The imposition of order comes in the form of rules, explicit or tacit, that guide the individual members' actions. These rules are imposed through organizational structure, such as a division of labor, to form an organization's cognitive network. An inquiry into organizational behavior and cognitive processes (such as learning) is dependent, then, on understanding how an organization is ordered—that is, how the organization has structured itself to allow for such structural elements as its division of labor.

The semantics can become convoluted, but how an organization is organized—that is, how it is structured and managed to allow for individuals to network and interact— influences group behavior and collective processes. Individual action and organizational structure, therefore, have a great influence on the firm's ability to act, learn and change. If an organization is made up of a collection of individuals, however, who act as agents for the functions attributed to the organization, how is an organization—as an entity itself—to be defined? Where is the line drawn between individual action and organizational action? Argyris and Sch\oen have defined an organization in one of two ways. An organization may

\textsuperscript{12} Ibid.

\textsuperscript{13} Ibid., p. 28.
be defined in how it is said to act or, alternatively, how it is said to know something or to learn. A collectivity can be defined as an organization when it is said to act as:

- a government or “polis”;
- an agency; or
- a task system.

Alternatively, an organization may be said to know something--or to learn--when defined as:

- a theory of action;
- a cognitive enterprise undertaken by individual members; or
- a cognitive artifact made up of individual images and public maps.

In each of these definitions, the concept of agency and the individual--or more appropriately, a collection of individuals--is still central to the notion of organizational being and action. When the mob has met the three sufficient conditions to organize itself, it takes on a collective identity and becomes a political entity (in the ancient Greek sense, a “polis”):

...Before an organization can be anything else, it must be in this sense political, because it is as a political entity that the collectivity can take organizational action. It is individuals who decide and act, but they do these things for the collectivity by virtue of the rules for decision, delegation and membership. When the members of the collectivity have created such rules, they have organized.

The organization, though made up of individual members who act as agents for organizational action, takes on a life of its own.

Even though it has its own identity and has in this sense become a political entity, the organization is still dependent on the networking of individuals for its existence. Individual perceptions and behavior, therefore, are central to the physical attributes and cognitive abilities exhibited by organizations. An inquiry into an organization’s cognitive

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14 Ibid., p. 12.
15 Ibid.
16 Ibid.
17 Ibid.
18 Ibid.
abilities--its ability to learn and change--must consider some of the organizational building blocks known as individual “images” and public “maps.”

- IMAGES AND MAPS:

As a political entity, the collectivity is able to interact to bind individual perceptions and values into a shared identity and sense of organizational “self.” How members build this common organizational identity is dependent, however, on their individual “images” and their shared vision of organizational “maps.” An “image” is defined as an individual’s perception and description of an organization in relation to his or her interaction with the rest of the organization. 19 This individual image is dependent, therefore, upon how the member perceives the organizational world and his or her position in it; it is dependent on the individual’s unique set of circumstances in relation to the rest of the collectivity. This definition recognizes the organic and dynamic ordering among individuals that is the basis for organization within the collectivity:

An organization is like an organism each of whose cells contains a particular, partial, changing image of itself in relation to the whole. And like such an organism, the organization’s practice stems from those very images. Organization is an artifact of individual ways of representing organization. 20

Individual images are combined and ordered to create a networking of identities and cognitive processes to form the organizational entity. How these individual “images” are networked creates the shared perception of order and structure that guides the organization in its collective action and behavior. This shared perception, therefore, serves as a normative internal reference for the organization, or what is known as the organization’s “theory-in-use”: 21

19 Ibid. p. 16.
20 Ibid.
21 Ibid.
...It is in this continual, concerted meshing of individual images of self and others, of one's own activity in the context of collective interaction, which constitutes an organization's knowledge of its theory-in-use.22

As the collectivity becomes an organization, the kind of an organization it becomes is dependent on how the order is imposed to form a task system—that is, how the organizational structure is applied so that the individual pieces are networked in such a manner as to allow organizational identity, delegation and decision making to take place. Consequently, there is a coalescing of individual components into something that has the potential to be greater than the sum of its parts. While an organizational structure may be imposed on the collectivity, the naturally occurring (and evolving) synaptic linkage forms an organization's theory-in-use—its normative way of operating despite the intended organizational design.

An organizational "map" is a public representation of an organization's theory-in-use.23 These public maps provide a more stable reference for individuals within the organization to help them identify the actual division of labor and guide their behavior. Maps can also serve as public references to help define an organization's structure and cognitive networking:

These [maps] are the shared descriptions of organization which individuals jointly construct and use to guide their own inquiry. They include, for example, diagrams of work flow, compensation charts, statements of procedure, even the schematic drawings of office space. ...They describe actual patterns of activity, and they are guides to future action.24

These shared maps, then, serve the dual function of internally guiding the complex network of individual interactions and providing an explicit external reference to help those outside of the organization better understand and define the collectivity.25

22 Ibid.
23 Ibid., p. 17.
24 Ibid.
25 Ibid.
While the organization's normative theory-in-use guides individuals in their organizational actions, it is important to note that relationships and shared perceptions are fluid and are continually being updated. It is common for there to be inconsistencies between the external references provided by an organization's "theory-of-action" (or "espoused theory") and its actual internal workings as represented by its "theory-in-use." 26 While an organization may create an external identity that appears stable, logical and explicit, it is by its very nature a more dynamic and organic collection of individuals and their images. An organization, as such, is always in the process of redefining itself; consequently, its espoused "theory-of-action" often differs from its "theory-in-use."

While an organization's espoused theory may be explicit, its theory-in-use may often have components that are more informal and tacit. 27 It is important to note, therefore, that an assessment of an organization's theory-in-use should "...be inferred from observation of organizational behavior—that is, from organizational decisions and actions." 28 Otherwise, there may be an unexplainable dichotomy in what an organization says and what it does. In addition, even though images and maps can provide reference points, individuals are continuously in the process of redefining their relationships relative to the rest of the organization. In this sense, individuals within the organization are always coming to know themselves, their roles, and their organizations better. An inquiry into organizational action and learning is concerned more with a process than a given state of being, or as Argyris and Schön stated:

...our inquiry into organizational learning must concern itself not with static entities called organizations, but with an active process of organizing which is, at root, a cognitive enterprise. Individual members are continually engaged in attempting to know the organization, and to know themselves in the context of the organization. At the same time, their continuing efforts to

26 Ibid. p. 13, 15.
27 Ibid., p.15.
28 Ibid., p.13.
know and to test their knowledge represent the object of their inquiry.
Organizing is reflexive inquiry. 29

An examination of collective perceptions and actions, therefore, yields information about organizational processes, not stable states.

Organizational learning is dependent on this individual learning. Individual learning, however, must be transferred to the organizational level, or as Argyris and Schön have affirmed, “...there is no organizational learning without individual learning, and that individual learning is a necessary but insufficient condition for organizational learning.” 30 Consequently, how individual inquiry is transformed into organizational learning defines a firm’s competence at handling change.

But how does learning take place? The learning process, both at the individual and organizational levels, is the subject of the next section of this thesis.

29 Ibid., p.16-17.
30 Ibid., p. 20.
THE LEARNING PROCESS:

Having defined an organization, the question then becomes how does an organization learn? To understand how organizations learn, it is first necessary to understand how individuals learn.

Individual learning is a process that, in its simplest form, has been described by David Kolb who refers to Kurt Lewin's four-stage experientially based cycle of learning.\(^{31}\) Graphically, Lewin's model is represented by the following diagram:

![The Lewin Experiential Learning Cycle](image)

The cycle begins as an individual collects concrete experience in a particular situation. The individual is then able to reflect on this experience as a means of conceptualizing new ways of thinking about a situation. Through "abstract thinking" the individual is able to formulate innovative approaches to a problem or inquiry. The new approach can then be tested through active experimentation which, consequently, gives the individual new concrete experience to reflect upon. The cycle can be repeated to respond to continuously changing environments or to facilitate continuous experimentation,

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innovation, and learning. Kolb describes learning using this model as a continuous process based on experience, information gathering, cognitive processing and experimentation. In this sense, he says, "ideas are not fixed and immutable elements of thought but are formed and re-formed through experience."33

One of the most noteworthy aspects of this cyclical model of learning is that action is based on a process of gathering and processing feedback. Individual and collective behavior (such as information sharing, formal or informal venues for discussion, and collaboration) are central to organizational action and learning. Individual and organizational effectiveness can be traced ultimately to an organization's information sharing capability and its competence in facilitating communication among individual members.34 The lack of adequate feedback processes within the learning cycle, for instance, can lead to an imbalance between observation and action, "...either from a tendency for individuals and organizations to emphasize decision and action at the expense of information gathering, or from a tendency to become bogged down by the data collection and analysis."35

Learning disabilities can also develop when the cycle is interrupted by individual resistance to participate or facilitate in the feedback, processing, or experimentation stages. In an earlier work, Argyris and Schön hypothesized that individual and collective perceptions ("images" and "maps") influenced organizational effectiveness:

We thought the trouble people have in learning new theories may stem not so much from the inherent difficulty of the new theories as from the existing theories people have that already determine practices. We call their operational theories of action theories-in-use to distinguish them from espoused theories that are used to describe and justify behavior. We

32 Ibid.
34 Ibid., p. 22.
35 Ibid., attributed to Kurt Lewin and his followers.
wondered whether the difficulty in learning new theories of action related to a disposition to protect the old theory-in-use.36

Organizational norms for behavior—whether explicit or tacit—often have a direct bearing on an organization’s ability to generate feedback and foster a learning environment. Organizational learning is, therefore, highly dependent on individual and collective attitudes and action as these directly impact feedback, collaboration, and information sharing.

In summary then, individual learning begins with an introspective assessment of one’s personal experience. Individually, we move from the experiential mode into a reflective mode and we get our feedback either from introspective thought or from feedback from others. New ideas and abstractions may be sparked by this introspection and feedback and can lead to individual experimentation to acquire new experience.

The Lewin model also serves to give us insight into how organizations learn. Organizations go through a similar cycle, but the collective experience is also taken into account and reflected upon collaboratively, as well as individually. This is a process I call “intraspective” because it is dependent on individuals looking outside of their own sphere, but conceptually staying within the defined bounds of the organization. As in individual learning, this intraspective process is dependent on collaborative communication to foster meaningful and diverse reflective feedback. It is an organic and symbiotic process that can be fostered, but not forced; individual and collective learning can be facilitated by establishing conducive environments, but not simply mandated.

Organizations, therefore, need to be cognizant of their structured environments and informal networks. Proper organizational structure and design facilitates the organizational learning process. Those organizations that are structured to allow—and actively promote—high levels of multi-disciplinary interaction and communication will realize higher levels of “organizational intelligence” and learning. These organizations may, in turn, attain higher

competence levels in dealing with change and may, therefore, be closer to the paradigm of the learning organization.

- SINGLE-LOOP LEARNING:

  Argyris and Schön have described organizational learning in terms of single-loops, double-loops, and deutero-learning, as opposed to the more simplified Lewin cycle. Single-loop learning is a process concerned primarily with error detection and correction. The organization’s normative behavior and identity are not questioned; its current theory-in-use is applied to assess whether an intended outcome is likely to be reached. In single-loop learning:

  ...members of the organization respond to changes in the internal and external environments of the organization by detecting errors which they then correct so as to maintain the central features of organizational theory-in-use. These are learning episodes which function to preserve a kind of constancy.37

This can be thought of as a lower-order of learning since the normative organizational values, which may be contributing to a problem, are not being questioned:

  Organizations are pretty good at single-loop learning. Budgets are set, based largely on past experience, and when the numbers start to come off-budget, the department, division, or company adjusts. It’s like the thermostat—if the room is too cold, the furnace kicks in. If the numbers are below budget, cut costs, sell harder, or raise prices. That’s just straight feedback—single-loop adjustment, and there is nothing wrong with it unless the environment changes.38

Organizations that engage primarily in this single-loop learning tend to evaluate success based on their effectiveness in accomplishing an intended outcome.39 Single loop learning is, therefore, primarily concerned with effectiveness, “...that is, how best to achieve

existing goals and objectives and how best to keep organizational performance within the range of specified existing norms. 40

Single-loop learning, while it may be collective learning, may not be organizational learning. Single-loop learning, since it involves mostly error detection and correction, may involve groups of individuals working together, but it may not lead to organizational adaptation within dynamic environments; nor may it give organizations the ability to anticipate changes or foster innovation. An organization must be willing to question its most fundamental elements, such as those embedded in its current theory-in-use. An examination of the cognitive network and process is as important as an assessment of an intended outcome. The organizational inquiry needs to call into question the very character of the organization itself; is there something in the structure or value system that needs to change or adapt to the environment? For organizational learning to take place, an organization’s theory-in-use, as defined by its individuals’ images and its organizational maps, must be open to alteration: 41

...in order for organizational learning to occur, learning agents’ discoveries, inventions, and evaluations must be embedded in organizational memory. They must be encoded in the individual images and the shared maps of organizational theory-in-use from which individual members will subsequently act. If this encoding does not occur, individuals will have learned but the organization will not have done so. 42

Organizations that may be highly competent in detecting errors and making changes to increase their overall success rate and effectiveness may not be engaging in a learning process that will allow them to adapt to changing environments.

A more holistic approach to organizational learning in which organizational norms themselves are open to modification, a process know as “double-loop learning,” describes a “reflexive” inquiry process that leads to organizational learning and change.

40 Ibid., p. 21.
41 Ibid., p. 20.
42 Ibid., p. 19.
• DOUBLE-LOOP LEARNING:

Organizations that exist and compete in highly dynamic environments may benefit by continually examining their existing theories-in-use and by making evolutionary changes at both the individual and organizational level. This requires a more complex and sophisticated learning process called "double-loop learning."

Double-loop learning involves a process that calls into question the most fundamental individual and organizational values, perceptions, and theories of action. According to Argyris and Schön, managers and workers must understand that they cannot achieve substantive change or evolution merely by "learning" to do better what they already know how to do (i.e., merely engage in outcome-oriented single-loop learning).43 To effectively bring about more continuous organizational change (evolution, as opposed to revolution), corporate managers and workers can participate in a collaborative inquiry process that questions the very structure and strategies of the organization itself.44 For instance, rather than simply add more staff or upgrade technology to meet increased work demands, a firm might ask is there a better way to go about doing the work in the first place? Who is involved, how are they working together, and is there another, better approach?

Continuous organizational change is not an easy or painless process; constant change presents a conflict for workers and managers in that it upsets the corporate norm for stability and predictability in the management of organizational affairs.45 The conflict arises when managers realize that there is a need for organizational change that can only be accomplished by changing the organization's normative standards and theory-in-use—its strategies and structures:

Hence, the corporate managers find themselves confronted with conflicting requirements. If they conform to the imperative for [change],

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43 Ibid., p. 21.
44 Ibid., pp. 22-23.
they must give up on the imperative for predictability. ...A process of change initiated with an eye to effectiveness under existing norms turns out to yield a conflict in the norms themselves.\(^6\)

Double-loop learning is, by definition, a form of organizational inquiry which resolves incompatible corporate organizational norms by setting new priorities and weightings of norms, or by restructuring the norms themselves together with associated strategies and assumptions.\(^7\)

Those organizations that are committed to realizing greater competence in dealing with dynamic environments and the associated organizational change it may necessitate will make the effort to engage in this double-loop learning type of inquiry. But as enlightened as these organizations may be, there is yet a higher level of learning and a greater degree of competence to be reached in dealing with organizational change.

**DEUTERO-LEARNING:**

Organizations that are engaged in continuous, reflexive inquiry to bring about evolutionary change can benefit by learning how to most effectively learn. Metaphorically, organizations are no different than children who, upon entering the first grade, need to learn how to learn; good learning skills and a conducive learning environment can lead to greater achievement.

Organizationally, continuous learning--or learning to learn--is what Gregory Bateson has called second-order learning, or “deutero-learning.”\(^8\) Organizations that routinely engage in deutero-learning usually give higher value and priority to creating an environment that fosters creativity and innovation.\(^9\) Deutero-learning also allows an organization to more effectively control and manage change.\(^50\) In essence, the organization

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\(^6\) Ibid.

\(^7\) Ibid., p. 24.


\(^50\) Ibid.
goes through the four stages of the Lewin cycle of learning with regard to the learning process itself:

*When an organization engages in deutero-learning, its members learn, too, about previous contexts for learning. They reflect on and inquire into previous episodes of organizational learning, or failure to learn. They discover what they did that facilitated or inhibited learning, they invent new strategies for learning, they produce these strategies, and they evaluate and generalize what they have produced. The results become encoded in the individual images and maps and are reflected in organizational learning practice.*

Learning to learn is the behavior and the domain of the learning organization. Turning an eye inward on the organization, valuing “intraspection” in its normative theory-in-use, allows a learning organization to achieve greater competence in dealing with change. The companies that make this extra-dimensional learning effort have better organizational skills and, therefore, have a greater ability to anticipate and exploit dynamic markets. These organizations may even gain a strategically competitive advantage and may learn to welcome and thrive on change.

Individuals, as agents for organizational action, can increase the collective cognitive ability of the organization by engaging in this higher-order learning activity. Deutero-learning can catalyze the double-loop learning process. Structuring an organization so that it may learn and become a better learner is, therefore, integral to the formation of a learning organization.

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51 Ibid., p. 27.
Organizational learning ability is dependent on how individuals are able to interact and how cognitive networks are allowed to form. How an organization is structured, therefore, influences a firm’s ability to engage in double-loop and deutero-learning. Firms that are structured to allow these higher-order types of learning can use restructuring as an effective intervention strategy to respond to changes in internal or external environments.\(^{52}\)

An organization that is actively involved in double-loop learning will allow itself to question its images and maps (its normative theory-in-use), including its structure. A firm can reflect on its experience with its current structure, engage in collaborative inquiry to generate potentially better ways of structuring, and actively experiment with structural modifications to gain new experience. It can then assess these structural changes to see if there has been an improvement in its organizational effectiveness. As an organization repeatedly engages in this double-loop learning process, it also learns what to expect during the four stages of the learning cycle itself. In other words, the organization learns to become more efficient at implementing change. In this respect, it is simultaneously engaging in deutero-learning as it learns how to learn, or how to more effectively handle the process of organizational change itself:

\[\text{An organization may be said to learn when it restructures itself in response to change in internal or external environment.}\]

But from the point of view of intervention, organizational learning has primarily to do with the ways in which members of the organization learn to select new structures and modify old ones so as to respond more effectively to changed conditions, or to create an environment more conducive to individual learning.\(^{53}\)

A firm, therefore, can respond to environmental change by making structural adaptations, by changing its theory-in-use and restructuring its fundamental physical and cognitive networking. The goal is to create an organization that is better able to perform its function.
(its mission) and better able to recognize and respond to future environmental shifts (to engage in double-loop and deuto-learning).

What kinds of organizational structure, however, facilitate this type of organizational inquiry, learning, and change? Are there organizational designs that include the appropriate structural elements to foster conducive individual and organizational learning environments? Is there such a thing as an organizational "structure" that can withstand, or even foster, continuous evolutionary restructuring as the organization itself learns and grows?

To answer these questions, it is first necessary to have an understanding of the basic types of organizational designs and structural elements. The next section of this thesis will, therefore, outline the five fundamental organizational structures described by Henry Mintzberg. In addition, the most important organizational structural elements will be discussed to build a framework that can be used to assess an organization’s potential learning ability.

- FORMS OF ORGANIZATIONAL STRUCTURE:

Henry Mintzberg has outlined five organizational configurations that he asserts can be used to broadly describe the structure of almost any firm. These are the simple structure, machine bureaucracy, professional bureaucracy, divisionalized form, and adhocracy.\(^{54}\)

In the case of the "simple structure," organizational coordination is achieved by direct supervision of a chief executive who gives orders and manages all of the daily operations of the firm.\(^{55}\) There is a minimum of operating staff and middle management. Most institutional real estate investment firms, however, manage portfolios that are too


\(^{55}\) Ibid., p. 105.
large and need to carry out a variety of functions that are too complex to allow for this type of direct, autocratic control.

A "machine bureaucracy" configuration occurs when a firm's primary concern is to standardize its work. As the firm focuses on having each of its work functions well-defined and controlled it builds a large administrative staff, particularly consisting of a technostructure (a highly skilled middle management) that is able to design and control the work standards. Since the nature of real estate development and investing does not lend itself to standardization, particularly during periods characterized by great instability and change, institutional investors in general have not gravitated towards machine bureaucracy structures.

When an organization, however, relies on the standardization of its employee's skills to coordinate its operations, it takes on the form of a "professional bureaucracy." It will have highly trained professionals in its operating staff and a large support staff to back them up. The skilled, highly trained professionals need less supervision to perform their work, so relatively little middle management is needed to carry out this function. The financial analysis, valuation, property management, accounting and reporting functions, for example, that are integral to most institutional real estate investment firms' operations can easily be coordinated through standardization of these essential skills; hiring well-trained, highly skilled professionals is, therefore, the norm at these firms. Most institutional investors, consequently, can be expected to have at least some of the attributes of a professional bureaucracy in their current organizational structures.

The "divisionalized form" of organizational structure is characterized by a firm that divides itself into parallel operating units, giving a certain amount of autonomy to the middle line managers of each unit. Overall coordination is accomplished by

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56 Ibid., p. 108.
57 Ibid., p. 109.
58 Ibid., p. 110.
standardizing the expected outputs of each unit (i.e., expecting a standard level of performance). In many respects, the institutional investors examined in this thesis were structured so that local offices operated as units autonomous to one another, but coordinated by a “home office” or “corporate office.” Real estate is, in many respects, a local commodity. The divisionalized form, therefore, naturally fits with a national institutional investor’s need to maintain extensive coordination, but retain local market knowledge and relationships.

Finally, the most flexible and adaptable firms are structured in such a way as to require sophisticated specialists to combine their efforts in project teams to organizationally form an “adhocracy.” Overall coordination is achieved by mutual adjustment and consensus; traditional managerial roles and departmental distinctions tend to break down:

*In today’s turbulent business environment, only organizations that adapt can survive. Older metaphors described organizations as efficient machines, an analogy that worked fairly well in more stable business environments. Each part of the organization served a single purpose. …Today’s environment demands a more organic, flexible model.*

The adhocracy structure is more fluid and decentralized; it relies heavily on the interplay and networking among individual members to continuously adapt and redefine its current operating patterns and structure. Its theory-in-use, therefore, is always open to modification which allows for an environment that is more naturally conducive to double-loop and deutero-learning.

From even these brief descriptions of organizational structures, it becomes obvious that an adhocracy can facilitate a firm’s ability to learn and continuously adapt to dynamic markets. As the environment in which a firm must operate becomes increasingly unstable, unpredictable, or more competitive, organizational intervention in the form of restructuring becomes an imperative:

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59 Ibid., p. 111.
there must be a process of reorganizing to deal with brutally competitive but constantly changing market circumstances. The management consultant, Henry Strage, has summarized the changes he has seen...in four words. "Alfred Sloan is dead." That classic corporate center with static planning systems; parallel administrative relationships between line and staff; common levels of authority and responsibility; identical processes among divisions for reporting, monitoring, and control; all united by a single, uniform approach to management development, compensation, and career planning is obsolete.

Instead we find divisions set up in whatever form seems to reflect strategic need, reporting to a small, flexible, elite corporate center that plays a variety of roles—coach, sponsor, surgeon, and architect are Strage's four categories.

This is the description of an adhocracy which can supplant the traditional organizational structures to more effectively deal with highly dynamic environments. A firm must first, however, have the ability to question its very structure before it can contemplate reorganization as an organizational intervention strategy. This requires double-loop and deutero-learning capabilities.

Mintzberg describes adhocracy as being the structure that "suits the industries of our age," meaning that it is flexible enough to accommodate the dynamic change, unpredictability and risk that characterize current highly competitive and volatile markets. Adhocracy makes an organization more reliant on its individuals--its human resources--rather than structural safeguards, such as centralization of control, to meet challenges and adversity. As Mintzberg asserts, "adhocracy relies on trained and specialized experts to get the bulk of its work done... [and these] experts must work together to create new things instead of working apart to perfect established skills." In other words, an adhocracy

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64 Ibid., p. 112.
Chapter Two

relies on its double-loop and deutero-learning capabilities to bring about collaboration and innovation.

When all around them markets are crashing and the instinct to survive is overpowering, managers must be courageous enough to go against convention, to take proactive steps to increase innovation, communication, and collaboration while their competitors take predictable defensive measures to bring more stability and certainty to their organizations. Those firms that centralize decision making and responsibility just when they should be freeing up and integrating organizational resources are merely trying to bring some semblance of order to frightening, often chaotic conditions. This crisis management, short-term approach tends to be rewarded as managers seem to bring about a sense of stability and control to an organization as market conditions deteriorate. The danger, however, is that the long-term health of an organization may be sacrificed as these managers try to control what inevitably is uncontrollable. A structural shift towards adhocracy is an alternative:

_Indeed, adhocracy contradicts much of what we accept on faith in organization—consistency in output, control by administrators, unity of command, strategy emanating from the top. It is a tremendously fluid structure, in which power is constantly shifting, and coordination and control are by mutual adjustment through informal communication and interaction of competent experts._65

The adhocracy structure offers organizations a unconventional alternative that recognizes the human element as the central organizational driving force.

It is important to note at this point in the discussion of organizational structures that Mintzberg's descriptions are generalizations; organizations rarely fit neatly into one organizational structure or another. Organizations are generally more complex entities that may take on more than one structural form at a time or may even combine elements of a different structures to create a hybrid. That is why, for instance, we can speak of

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65 Ibid., p. 111.
“bureaucratizing” or “adhocratizing” an organization, mixing elements of different structures. The combinations and possibilities are virtually infinite.

In addition, related literatures have used alternate methods of describing and grouping organizational structures. Project-oriented firms, such as accounting firms, aerospace firms, construction firms and real estate development companies, are often examined against a framework that delineates how their technical specialties are grouped, how well they are suited to operate in dynamic environments, and how their decision making processes have been decentralized. It is worth mentioning a few other structures which have had prominence in the organizational structure literature in recent years, particularly the functional, project, matrix, and integrated organizational structures. A few brief definitions are in order:

- A firm that is functionally structured separates its technical skills and specialties into divisions; the firm’s various functions (i.e. valuation, asset management, property management,...) are functionally grouped into distinct departments. Functionally structured firms generally opt for decentralized decision-making and are known to operate well in stable environments.

- A firm that is structured to be project-oriented combines members with different technical or specialty skills into project or client teams; there may be little association, however, between an individual’s technical skills and department grouping. The project-oriented firm often has decentralized its decision making processes and operates well in moderately unpredictable, dynamic environments.

- An organization that has taken on a matrix structure forms project or client teams with members retaining relationships and identification with broader functional skill-based divisions. The matrix structured firm operates best in

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68 Ibid.
dynamic, unpredictable markets and is always accompanied by decentralized
decision-making processes.69

- The *integrated* structured organization emphasizes flexible and market-
oriented grouping of individuals across disciplines and functional divisions.
Relationships, reporting, and communications are complex and difficult to
manage over the long-term. The integrated structure is always accompanied
by decentralized decision-making and is best suited to firms that operate in
dynamic, unpredictable, highly competitive environments.70

These four definitions illustrate an alternate way of describing a firm’s structure.
The idea, however, is not to become proficient in being able to define and label an
organization’s structure, but to be able to identify an organization’s particular
characteristics, its structural elements, that influence its ability to learn and deal effectively
with continuous change. It is less important to peg an organization as being a firm with,
say, a divisionalized form that works as a professional bureaucracy at the subunit level than
it is to understand the impact that this structure may have on the organization’s learning
ability.

A firm’s ability to learn—its ability to engage in individual and organizational
inquiry, generate feedback, create new ideas, and actively experiment with changes—is
dependent on how its structural elements come together to facilitate or inhibit the learning
process at each stage of the cycle. What are the structural elements that influence a firm’s
learning abilities—or disabilities? How can organizational learning and evolutionary
change be facilitated by a firm’s structural components?

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69 Ibid.
70 Ibid.
Chapter Two

- **Organizational Structural Elements:**

Henry Mintzberg outlines several structural elements that serve as the building blocks for organizational action. How these basic components are assembled defines the learning ability and flexibility that the organizational structure can support.71

- **Specialization of tasks** refers to the number of tasks and the complexity of those tasks that are assigned to a particular job. As referred to earlier, a firm creates a task system (a division of labor) as it coalesces from a collectivity into an organization. This gives an initial task system to the firm which can continue to evolve and become more specialized.

- **Formalization of procedures**, or *behavior formalization*, refers to the standardization of work processes via a firm's explicit organizational maps (i.e. operating instructions, job descriptions, rules, employee guidelines, etc.). This is often thought of as "bureaucratizing" the work and organization.

- **Formal training and cultural indoctrination** refers to the use of formal instructional programs used by firms to establish and standardize the necessary skills, knowledge and company norms (corporate culture) in its employees.

- **Grouping of units** refers to the manner in which sectors or functions within the organization are grouped together into units and how these units are grouped into higher-order units. The various methods for grouping organizational units (i.e. by skill base, technology used, product, geography, client base, etc.) can be summarized into two fundamental categories: Grouping by the *function* performed, or grouping by the *market* served.

- **Size of each unit** refers simply to the number of positions grouped into a particular unit; this usually correlates directly to the number of employees, although one employee may serve multiple functions and fill multiple positions.

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• **Action planning and performance control systems** are management's way of standardizing ("bureaucratizing") a firm's or division's outputs. Action planning is prospective in that it is an attempt to specify the result of taking a particular action. Control systems are used after-the-fact to evaluate the performance or quality of a given action or program.

• **Liaison devices** are used as mechanisms to facilitate communication, collaboration, and consensus (what Mintzberg calls "mutual adjustment") among a firm's various units and subunits. These may take many forms, including integrating managers, formal interdisciplinary meetings, or informal communications and information sharing among employees.

• **Delegation of power** is divided between vertical decentralization and horizontal decentralization. A firm that is vertically decentralized has delegated much of the decision-making authority and responsibility down its managerial line of command, often to divisionalized or satellite offices and their respective chains of command. A firm that has horizontally decentralized has deliberately incorporated its non-managers—its workers, whether they are highly skilled professionals or support staff—in the decision-making processes related to their jobs. Institutional investors often exhibit what Mintzberg calls *limited vertical decentralization* or *parallel decentralization*, "where managers of market-based units are delegated the power to control most of the decisions concerning their line units." 72

No matter which structure a firm may chose or exhibit, how it approaches each of these fundamental structural elements has a great impact on its ability to learn and change. Structural elements, however, are only half of the organizational structure equation. The other half is made up of what the literatures refer to as elements of situation.

• **Organizational Elements of Situation:**

While structural elements are internal to the organization, situational elements are generally related to factors external to the organizational entity itself, often things beyond its control. For the purposes of this thesis, only a few situational elements will be discussed,
in particular those situational elements related to an organization’s “technology” and “environment.”

An organization’s “technology” refers how a firm performs its work, how it transforms its inputs and outputs and adds value in the process. The three most important aspects of technology that affect an organization’s structure (and, therefore, its ability to learn and change) are complexity, uncertainty, and interdependence.73

“Complexity” refers to the number of different factors that the firm has to take into account as it performs its work. A company, for instance, that purchases multi-use, multi-tenanted commercial properties for third-parties would use more complex technology in its work than a company that made cash purchases of vacant land for its own portfolio. Complexity, as a situational element, is directly related to organizational structure in that the more complex an organization’s technology, the more complex its structure will have to be to accommodate the work.74 For example, as the work gets more complex, the firm needs to differentiate, but still coordinate, a growing number of related tasks. The complexity of the firm’s structure increases to allow for greater specialization of its workforce as a means of managing the multiple tasks. This structural complexity is then compounded by the need to integrate the various differentiated functions and specialists via liaison devices.

“Uncertainty” in the technology refers to the variability or unpredictability of the elements upon which the work is performed.75 Uncertainty often affects organizational structure by influencing how a firm’s decision-making processes are organized, how responsibility and authority are distributed. In general, more uncertainty and more unpredictability means that decisions need to be less standardized. Structurally speaking, this means that decision-making needs to be more decentralized:

*The more uncertain an organization’s technology is, the more decentralized its decision making will need to be and the less formalized its*
structure.  *Because McDonald’s has a certain technology, decision making can be centralized and the organizational structure formalized.*  

_Firms involved in management consulting tend to be at the other end of the spectrum. How the problem is to be solved is not known going in._76

In real estate investment and development, this need for decentralization often seems counterintuitive to those in control of the decision making process (usually top management). For instance, when sources of capital are scarce or when costs of capital are highly variable, the decision to participate in a real estate deal becomes more complex and risky. Rather than decentralize decision making to rely on the local expertise and the wealth of accumulated organizational experience, decision making and control tend to become more centralized.

“Interdependence” in a firm’s technology refers to the extent to which a firm’s inputs, outputs and work processes are interrelated to one another; a change in one factor, may have a great impact on other factors. A change in the vacancy rate of a building or a change in the applicable market rents charged, for instance, would have a great impact on a property’s value. Similarly, the marketing, brokerage, asset management and valuation functions of a real estate investment firm must be coordinated to recognize their interdependence in a real estate organization’s work processes:

…the more interdependent an organization’s technology is, the more the organization will need to use coordinating mechanisms [in its structure] such as task forces, liaison roles, specific integrating departments, or…talented generalists with the ability to appreciate the interdependencies.77

The technological interdependence of a firm’s work processes, therefore, must be recognized and accommodated in a firm’s organizational structure.

These three situational elements related to an organization’s technology—complexity, uncertainty, and interdependence—must be taken into account as part of an

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76 Ibid.
77 Ibid.
inquiry into organizational structure. A well-designed organization has a structure that allows it to perform its work and achieve its mission in an expedient and effective manner. Its structure allows a range of people and skills to be combined and coordinated in such a way as to produce something that could not be produced individually:

*While each task individually is not technically demanding and would not require the intellect of a rocket scientist, the number of tasks, the uncertainty of outcomes at each step, the unknowns, and the interrelatedness can turn a simple series of tasks into a bewildering maze for the uninitiated.*

Organizational structure that reflects the technological variabilities of the work situation can serve to orchestrate individual efforts and talents into a successful collective undertaking. The structure, however, must be open to modification as the situational elements change.

There are also organizational elements that are affected by the *environment* in which a firm must operate. A business environment may vary in its complexity, in how dynamic it is, in its competitive nature, or in its dependence on related industries or markets, to name but just a few factors. These type of environmental factors, however, tend to affect a firm's organizational structure in predictable ways. Mintzberg, for instance, has said that the more complex an environment is, the more need there is for structural decentralization to help central management collect and comprehend data. He also asserts that more dynamic markets call for less bureaucratic, less standardized work outputs, skills and organizational structures.

Structurally, the pull is between centralization and decentralization of work processes and decision-making. In times of trouble (a euphemistic description for the current real estate environment), there is often an organizational dichotomy in which crisis-management dictates a move towards centralization, but in which the need for greater integrative flexibility, sources of local information, and depth of organizational experience

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78 Ibid.
80 Ibid.
(all of which are best attained through decentralization) are sacrificed. Issues relating to financial control and accountability should not override the long-term benefits of empowering local expertise and building stronger, reliable, decentralized relationships. This requires a delicate structural balance or what Archier and Serieyx describe as the "simultaneous loose-tight" organizational character of a "Type 3 Company":

*The excellent companies are both centralized and decentralized. For the most part, as we have said, they have pushed autonomy down to the shop floor or product-development team. On the other hand, they are frantic centralists around the few core values they hold dear.*

Real estate--with its buildings, land, loans, tenants, leases, contractors, investors, etc.--is still a local business based on local expertise and local relationships. This need for decentralization, particularly during times of adversity, needs to be reflected in the organizational structure of even the most high-tech and geographically diversified real estate firms. When markets crash and managers jump into a crisis-management mode, however, even the most simple and fundamental principles can get lost in the panic. Organizational change to accommodate new market conditions may be needed. Some firms that are continuously involved in change and view change as a business lifestyle--such as those set up as adhocracies--will put their double-loop and deutero-learning thinking caps on; these firms will motivate their employees to experiment with new ideas and innovative solutions, even if it means reorganizing the firm itself. Other firms that opt more for revolution than evolution will wait until the external stress is too great; while they may make minor adjustments along the way, they will only make major, painful structural changes when forced:

*Unfortunately, some managers take a more passive approach to minimizing the risk inherent in change by waiting until a situation is so dire that staying the same may involve a greater risk than making change....*

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82 Ibid., attributed to Peters and Waterman from their book *In Search of Excellence*. 

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Chapter Two

The greatest drawback to a last resort approach to organizational change is that, by then, one of your most valuable resources will likely be in short supply. That resource is time... When the business itself is in serious trouble, time tends to be used to fight fires, rather than to perform careful analysis and planning for the future.83

And then there are those firms that, no matter how well intentioned, cannot seem to make significant organizational changes. These firms are blocked and have learning disabilities that can ultimately lead to organizational obsolescence—and insolvency.

• OBSTACLES TO CHANGE:

All organizations, no matter how well structured, enlightened or progressive need to be aware of potential learning disabilities which can act as obstacles to organizational change. The structural components of some firms lead to a short-circuiting of the learning process at a critical point in the four stage cycle; others may deliberately pursue a strategy to discourage change in order to maintain internal consistency and a reassuring image of stability. While learning disabilities can come in an almost infinite variety of both structural and strategic forms, the following is an outline of some of the more prevalent organizational obstacles to change.

• Competency traps:

Sometimes effective learning strategy is counterintuitive. Organizations, for instance, need to be wary of success because it can lead to what is known as a “competency trap.”84 Organizations, like individuals, build their competence in the skills and procedures that lead to desirable outcomes. Individuals tend to trust what has worked for them, and organizations, as collections of individuals, tend to trust and standardize those behaviors and processes that have lead to past success. In time, however, this leads an organization

to rely on the skills that help it to maintain a satisfactory status quo. An organization that is not continuously in the process of questioning its normative processes risks becoming so invested in a particular way of doing things that it resists change—it gets trapped by its own competence:

...a competency trap can occur when favorable performance with an inferior procedure leads an organization to accumulate more experience with it, thus keeping experience with a superior procedure inadequate to make it rewarding to use. 85

A classic example of such a competency trap is when a worker becomes proficient with a particular computer system, and resists changing to another, even better, system. The worker is loyal to the behaviors and processes in which he or she has become invested and grown competent; change, particularly when it has not been precipitated by an identifiable failure, is threatening. In general, “non-failure” related experience with a particular procedure or technology leads individuals and organizations to persist in using procedures or technologies that may be far from optimal. 86

Similarly, when an organizational structure or strategy works, a firm must still periodically ask itself if it has worked well enough—is there a better way? If a firm waits until it experiences “failure” before it questions its normative processes, it will not engage in the higher-order forms of learning that result in organizational change. In addition, success is not easy to define in such a difficult real estate market. Some institutional real estate investor’s may view “success” in today’s market not in terms of who profits most, but as a matter who loses the least or who will survive until conditions improve. While merely maintaining the status quo may seem like an achievement, companies need to strive for more. Firms need to adapt to market changes—to learn and to evolve—in both good times and bad.

85 Ibid.
86 Ibid., p. 323.
Chapter Two

- **Misinterpretation of Causal Relationships:**

  A clear cause and effect relationship in complex business situations is difficult to definitively trace or understand. Outcome-oriented learning (i.e., single-loop learning) can lead to “solutions” that are predicated on improper assumptions.\(^{87}\) Sometimes this takes the form of “superstitious learning” in which subjective experience seems compelling, but the connections between organizational actions and outcomes are unclear.\(^{88}\) Did new elevators in an office building make the property more competitive and more profitable, or were other factors involved (i.e., new property management, fortuitous lease renewals, debt refinancing, etc.)? Should other underperforming office buildings be given costly physical upgrades?

  Individuals have a need to impose a sense of order on their world, especially when faced with ambiguous or unpredictable situations. The problem can be compounded in an organizational setting, particularly when individuals or groups are called upon to demonstrate their competence. Organizational behavior, therefore, often encourages individuals to make tacit, if not explicit, assumptions about causal relationships. If an individual misinterprets the cause of a particular outcome at any stage within the learning cycle, the organization can develop a learning disability and its future ability to adapt may be impaired.

- **Organizational Mythology:**

  Every organization has its own form of normative behavior, its own set of values and “corporate culture.” Common interpretation of past events, collective understandings of company history, and shared perceptions of experience can create a strong organizational mythology. Organizations tend to perpetuate their mythology as “participants collude in support of interpretations that sustain the myths.”\(^{89}\) Any individual or group action that

\(^{87}\) Ibid.
\(^{88}\) Ibid., p. 325.
\(^{89}\) Ibid., p. 324.
threatens this mythology may be met with indifference or even intolerance. A learning organization is always in the process of questioning its values and redefining itself as it evolves. Organizations that block this process in order to preserve their mythology create obstacles to change.

- **Individual Non-enrollment:**

  Organizations are complex entities made up of groups, sub-groups and individuals. Each may have a different perspective or definition of success, as well as a different interpretation of a firm’s experience. Well-defined organizational targets and missions can help to orchestrate this diversity of opinions and efforts into a productive collective effort; if all participants are at least moving in the same direction, the organization can grow and evolve. However, individuals or groups that even tacitly oppose the direction being pursued will either contribute nothing to the effort or, worse yet, may actively block organizational activity.\(^{90}\) Individuals, therefore, need to become enrolled in an organization’s overall mission and in the incremental goals that often serve as discrete learning experiences along the way.

- **Crisis Management:**

  When markets are turbulent and organizations face unusual difficulties, it is easy for individuals to suspend normative practices and to slip into a crisis management mode—the instinct for survival can be overpowering. Crisis management, however, is nothing more than an organization’s way of suspending its long-term objectives in order to meet more urgent short-term needs.\(^{91}\) As a short-term strategy, crisis management may be effective, but it presents a danger if it persists long after it is appropriate and productive.

  To managers and workers grasping to gain control over unstable or threatening conditions, crisis management may seem more entrepreneurial and dynamic. It can result,

\(^{90}\) Ibid., pp. 325-326.
\(^{91}\) Ibid., p. 327.
however, in organizational learning disabilities as innovations and learning-induced changes often fail to become recorded in a firm’s “organizational memory.” If the crisis mentality outlasts the actual precipitating crisis, the long-term objectives and well-being of the organization can be overlooked. If care is not taken to embed short-term innovations into the organization’s long-term normative behavior, success can be ephemeral.

• **Bureaucratic Controls:**

Another danger of crisis management is that is often leads to bureaucratic obstacles to change. Organizations must strike a balance between their need for control and continuity and their need to remain flexible and adaptive. Particularly when trouble abounds, organizational experience and trusted relationships can be lost as turnover of personnel increases; financial controls are often tightened to enhance reporting capabilities and reassure top management or stockholders and work processes; and outputs become more standardized. As the organization becomes more bureaucratic, it creates new sets of rules and routines—and then rewards individuals for compliance.

When organizations must exist in chaotic environments, their defense mechanism is to impose order, to control whatever can be controlled. Predictability is comforting while surprise—even serendipitous surprise—is distressing. The net effect is to stifle individual creativity, create organizational advocates for routines, and encourage rule zealotry. Organizational bureaucracies also tend to discount the importance of innovation and surprise as fortuitous engines of unexpected experimentation and success. When creativity and experimentation are impeded, the learning cycle is disrupted.

• **Communication Barriers:**

Feedback and information sharing are critical elements in the collective process of the organizational learning cycle. Firms that encourage formal and informal communication

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92 Ibid., p. 328.
93 Ibid., p. 329.
provide better access to information and facilitate collaborative inquiry. Organizations, however, unwittingly create incentive for territorial protection of information by rewarding individual performance.\textsuperscript{94} Similarly, individuals or departments are given a disincentive to share information if they have reason to believe they will be punished, or at least not rewarded, for disclosing disappointing results. Firms that inhibit communication and collaborative interaction by allowing or incentivizing individuals to withhold information create functional learning disabilities and, consequently, obstacles to organizational evolution.

Organizations need to understand that the experimentation phase of the learning cycle does not always lead to improvement or success. Organizations must expect and make allowances for a healthy level of failure.\textsuperscript{95}

\textit{Put simply, because many professionals are almost always successful at what they do, they rarely experience failure. And because they have rarely failed, they have never learned how to learn from failure. So whenever their single-loop learning strategies go wrong, they become defensive, screen out criticism, and put the "blame" on anyone and everyone but themselves. In short, their ability to learn shuts down precisely at the moment they need it the most.}\textsuperscript{96}

Individuals need to be given the license to fail if they are called upon to risk success. While interim goals should be recognized and rewarded, a firm’s compensation system should be tied to organizational (not individual) performance which can only be effectively gauged over the long-term.

- **CHAPTER CONCLUSIONS:**

The framework for organizational change outlined in this chapter serves as a basis to explore the organizational structures and learning abilities of institutional real estate

\textsuperscript{94} Ibid., p. 331.
\textsuperscript{95} Ibid., p. 334.
investment firms. The following chapters use this framework to compare two firms that have experienced varying degrees of real estate trouble and have exhibited different preferences for organizational change. General conclusions presented in the final chapter of this thesis will draw from these two cases and the academic framework presented here.
Enormous change has occurred in the last few years within the commercial real estate industry, the scale of which is only now being recognized. For instance, the total value of U.S. commercial real estate, estimated at about $3.5 trillion in 1989, has declined by approximately 30%—a loss of about $1 trillion. Comparatively speaking, this loss amounts to nearly twice the dollar amount lost in the U.S. stock market during the October 19, 1987 crash. Institutional investors would like to believe that values cannot decline much further, but recent reports say that overall real estate values may decline by another 15% or more in the coming year. The future stakes are enormous, as pointed out in greater detail in Chapter One.

Institutional real estate investors have no taxpayer financed government safety-net, no comparable government bailout on the scale of the savings and loan industry rescue, waiting in the wings. The institutional real estate investment community is on its own and individual firms, therefore, must recognize the fundamental changes that have occurred and must adapt their organizations to do business in this new environment. Those that adapt will survive; those that learn to evolve along with the incremental shifts in the business environment may have an even better chance at prospering.

Falling property values, soaring vacancy rates and tight credit markets, however, have brought financial illiquidity--and even insolvency--to some of the formerly most stable institutional real estate investors. The corporate instinct for survival has taken over as managers talk about making their firms leaner, smarter, and more efficient. But what do these words mean? It is relatively easy to trim staff and eliminate unnecessary expenses, but are institutional investors making changes that will actually make their

2 Hemmerick, Steve, “Real estate may drop 15% more,” *Pensions & Investments*, April 27, 1992, p.35.
organizations smarter and more competitive? Can organizational restructuring be used as an effective intervention strategy to allow firms to more effectively deal with change?

All types of institutional investors are experiencing their share of real estate related trouble. Already over 700 banks have failed and, according to the Congressional Budget Office, another 600 thrifts will need to be taken over by the RTC. The mightiest real estate empires have been decimated as evidenced by Olympia & York Development Ltd.’s Chapter 11 bankruptcy filing. Westinghouse Financial Services, an institutional finance company that is a subsidiary of Westinghouse Electric, lost almost $2.5 billion in since 1990, most of which was attributed to commercial real estate problems.

The most surprising news for the average citizen, however, may be that the insurance companies--those supposedly unsinkable bastions of stability whose primary mission is to come to the rescue when, all around, the world seems to be crumbling--have been rocked by the current real estate crisis. Liquidity problems and huge portfolios of real estate equity and debt exposure spell trouble for most insurance companies.

THE LIFE INSURANCE INDUSTRY’S INVESTMENT IN REAL ESTATE

How much real estate exposure do the insurance companies have? It is difficult to quantify precisely, but recent reports state that life insurers have about $303 billion invested commercial real estate on their own behalf ($256 billion in commercial mortgage loans and $47 billion in direct equity ownership). This figure, however, is only what the insurers have invested for their own accounts; investing for the accounts of others makes up a substantial portion of the insurers real estate investment management business. We know, for instance, that the pension funds have most of their $100 billion in real estate investments managed by insurance company realty managers. The total

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4 Op. Cit., Carol J. Loomis, p. 73.
5 Ibid., p. 73.
exposure by the insurance companies, therefore, may approach nearly a half trillion dollars.

The following table gives a status report, as of December 31, 1991, of the ten largest life insurance companies ranked in order of their total dollar amount of real estate exposure: 6

<table>
<thead>
<tr>
<th>LIFE INSURANCE COMPANIES</th>
<th>COMMERCIAL REAL ESTATE ASSETS</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total† as of 12/31/91 in millions</td>
</tr>
<tr>
<td>Prudential of America</td>
<td>$29,200</td>
</tr>
<tr>
<td>Metropolitan Life</td>
<td>$27,867</td>
</tr>
<tr>
<td>Teachers Insurance &amp; Annuity</td>
<td>$21,945</td>
</tr>
<tr>
<td>Aetna Life</td>
<td>$19,071</td>
</tr>
<tr>
<td>Travelers</td>
<td>$13,404</td>
</tr>
<tr>
<td>Equitable Life Assurance</td>
<td>$12,173</td>
</tr>
<tr>
<td>John Hancock Mutual Life</td>
<td>$11,135</td>
</tr>
<tr>
<td>Connecticut General Life</td>
<td>$10,081</td>
</tr>
<tr>
<td>Northwestern Mutual Life</td>
<td>$6,998</td>
</tr>
<tr>
<td>New York Life</td>
<td>$6,900</td>
</tr>
</tbody>
</table>

† The total asset amounts do not include real estate held in joint ventures or separate accounts managed for customers.

After the insolvencies of Executive Life Insurance and Mutual Benefit Life Insurance, the U.S. Congress is considering federal regulation of the insurance industry, but regulation neither promises a taxpayer financed bailout nor an intelligent restructuring of those individual organizations beset with problems. Insurance companies need to face their own troubles and must learn how to use restructuring as an organizational intervention strategy to more effectively deal with the new set of real estate challenges

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6 Table based on information given in a Fortune Table, “Victims of the Real Estate Crash,” Fortune, May 18, 1992, p. 76.

7 Ibid., p. 78.
they now face. Some firms, for instance, that were primarily lenders must now adopt an owner’s perspective as the number of defaults and foreclosures swell their REO (real estate owned) portfolios. Conversely, firms that were borrowers or took equity positions in real estate investments must understand the needs of lenders and the sophisticated mechanics of debt restructuring. Even those real estate assets that are relatively healthy need to be well-managed so that they weather the market turbulence and maintain or improve performance. Asset management, consequently, is a growing technical specialty that has applications for both performing and non-performing assets.

- **FIELD RESEARCH METHODOLOGY:**

  The next sections of this thesis present data regarding the organizational structure and organizational learning capabilities of two insurance company affiliated real estate firms, Equitable Real Estate Investment Management Company Inc. and the Travelers Realty Investment Company. The local Boston offices of these two firms were chosen because they represent two institutional investment companies from the same industry that are experiencing different amounts of trouble in their respective portfolios of real estate assets. Equitable’s troubled asset problems are relatively minor, while Travelers’ real estate related problems are massive. These two field research sites held potential for undertaking a comparative analysis of institutional investors. Field research and interviews conducted at these two real estate investment firms allowed for a comparison of their internal operations, organizational structures, and organizational learning capacities.

  Interviews were conducted with key personnel of the local Boston offices of these two firms. At Equitable Real Estate, three of the five functional discipline heads, as well as the head of the office and two other regional manager were interviewed. A total of nine interviews were conducted with five different individuals at the Boston Equitable Real Estate office representing over 10 hours of interviewing. Interviews generally
averaged a little over an hour each. The head of the Travelers Realty office and two of the three other loan officers were interviewed. This represented a majority of the entire office’s professional staff. Five interviews were conducted representing about six hours of meetings.

Specific questions were posed to each of the interviewees at the two firms to gather information about:

- The historical background relating to the organizational structure and business strategy of each firm;

- The status of each local office’s real estate portfolio with respect to performing and non-performing assets;

- Changes that have led to the acquisition of new skills or a redeployment of existing organizational resources;

- The degree of functional skills and decision making authority that had been centralized or decentralized;

- The formal and informal information sharing venues developed to facilitate communications among office personnel and between levels of organizational hierarchy; and

- Differences between the firm’s formal organizational structure--its division of labor and organizational chart--and its tacit operational way of doing business.

This information is presented and analyzed against the frameworks for organizational structure and organizational learning discussed in Chapter Two. The information gathered from Equitable Real Estate and Travelers Realty is presented first in a tabular form for ease of reference then discussed in greater detail in the following sections to allow for more in-depth comparison and analysis. This information was reviewed and checked for accuracy by each firm prior to its inclusion in this thesis in final form.
## Field Research Data Comparative Matrix:

<table>
<thead>
<tr>
<th></th>
<th>Equitable Real Estate</th>
<th>Travelers Realty</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total Portfolio Value</strong></td>
<td>$37 billion</td>
<td>$15 billion</td>
</tr>
<tr>
<td><strong>Boston Office Portf. Value</strong></td>
<td>$1.5 billion</td>
<td>$500 million</td>
</tr>
<tr>
<td><strong>Percentage of Total Portfolio Classified as “Non-Performing”</strong></td>
<td>6%</td>
<td>36%</td>
</tr>
<tr>
<td><strong>Business Focus</strong></td>
<td>1.) Asset management</td>
<td>1.) Workouts</td>
</tr>
<tr>
<td></td>
<td>2.) New business</td>
<td>2.) Asset management</td>
</tr>
<tr>
<td><strong>Significant Business Factors &amp; Considerations</strong></td>
<td>• Demutualizing</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Public image sensitivity</td>
<td>• Credit-rating lowered</td>
</tr>
<tr>
<td></td>
<td>• Liquidity problems</td>
<td>• Negative media attention</td>
</tr>
<tr>
<td><strong>Business Strategy</strong></td>
<td>• Maintain stability and internal consistency</td>
<td>• Restructure organization</td>
</tr>
<tr>
<td></td>
<td>• Better asset performance</td>
<td>• Foreclose and manage troubled assets in-house</td>
</tr>
<tr>
<td><strong>Organizational Structure</strong></td>
<td>• Divisionalized with decentralized operations</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Professional bureaucracy</td>
<td>• Vertical integration of functional generalists</td>
</tr>
<tr>
<td></td>
<td>• Vertical integration of functional disciplines</td>
<td></td>
</tr>
<tr>
<td><strong>Field Office Management</strong></td>
<td>• Regional office manager</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Functional discipline heads</td>
<td>• Office manager supervises tech/prof staff</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Corporate office supervises local administrative staff</td>
</tr>
<tr>
<td><strong>Responsibility</strong></td>
<td>• Decentralized</td>
<td>• Decentralized</td>
</tr>
<tr>
<td><strong>Authority &amp; Decision Making</strong></td>
<td>• Centralized</td>
<td>• Centralized</td>
</tr>
<tr>
<td><strong>Turnover &amp; Personnel Shifts</strong></td>
<td>• Stable</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>• New corporate leader (workout specialist)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• High incidence of internal personnel shifting</td>
</tr>
<tr>
<td><strong>Evolution vs. Revolution</strong></td>
<td>• Revolution</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Was revolution</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Now more evolution</td>
</tr>
<tr>
<td><strong>Types of Learning Exhibited</strong></td>
<td>• Primarily single-loop</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Some double-loop</td>
<td>• Mostly single-loop</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Some double-loop</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Possibly deuto-learning</td>
</tr>
<tr>
<td><strong>Information Sharing &amp; Information Access</strong></td>
<td>• Annual business plan review</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Circulation of written portfolio activity reports</td>
<td>• Annual portfolio review</td>
</tr>
<tr>
<td></td>
<td>• Company-wide computer network</td>
<td>• Circulation of staff meeting minutes</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Company-wide computer network</td>
</tr>
<tr>
<td><strong>Reactive vs. Proactive</strong></td>
<td>• Reactive</td>
<td>• Primarily reactive</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Some proactive</td>
</tr>
</tbody>
</table>
Chapter Three

- EQUITABLE REAL ESTATE INVESTMENT MANAGEMENT INC.:  

Equitable Real Estate Investment Management Inc. is a wholly owned subsidiary of the Equitable Life Assurance Society of the U.S., the nation’s fifth largest life insurance company. The primary function of Equitable Real Estate is to manage all of its parent company’s real estate assets and to manage real estate investments for third parties. Equitable Real Estate participates in debt and equity real estate investments for its own account and “the accounts of others” throughout all major U.S. markets, Canada, and Puerto Rico. Its third party investment management business grew significantly in the 1980’s with the influx of capital from the domestic pension market, including both public and private funds; the Far Eastern market, particularly Japanese funds; and the European market, predominantly British, Dutch and Middle Eastern funds.

Equitable Life’s real estate portfolio is valued in 1992 at about $14 billion with $4 billion in equity investments and $10 million in debt.8 Adding third party investments (mostly from pension funds) brings Equitable’s total real estate portfolio to about $37 billion.9 The Boston office currently manages a portfolio of real estate valued at about $1.5 billion, with approximately $1 billion in equity investments and about $500 million in debt. Approximately 6% of Equitable’s real estate portfolio is considered “non-performing” (60 days or more past due). The Boston office of Equitable Real Estate has had relatively few troubled assets either on the equity or debt side and, according to the office’s regional manager, does not have any workout situations remaining in its portfolio. As a borrower, this regional office has defaulted on only one loan in the past 12 months (which it did, it said, in a strategic move to force its lender to the negotiating table).10 As a lender, it has had to foreclose on only two mortgages within the past eight

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8 Figures provided by the Executive Vice President, Equitable Real Estate Investment Management Inc., Boston, MA, June 17, 1992.
9 Ibid.
10 Interview with the Vice President, Valuation, Equitable Real Estate Investment Management Inc., Boston, MA, June 30, 1992.
years, both owing to what was referred to as mismanagement on the part of the borrowers. With few troubled assets and no workouts in its portfolio, Equitable Real Estate’s Boston office is able to focus its efforts on asset management and new business. According to the office’s regional manager, the biggest challenges facing the firm are “how to get existing assets to perform better and how to find new business in a marketplace that will basically be stagnant for the next few years.”

Equitable Real Estate’s parent company, Equitable Life, is in the process of converting from a mutually-held (policyholder owned) to a publicly-held (stockholder owned) company. This process of demutualizing is being undertaken in an effort to raise new capital to bolster the company’s liquidity. The firm’s initial stock offering occurred in July, 1992 at about $9.00 per share, less than originally expected. This initial public offering raised about $450 million in new capital and triggered an automatic conversion from debt to equity of a $1 billion investment by the large French insurance firm, Groupe Axa S.A.

This move to demutualize and the need to raise new capital appear to have influenced Equitable Real Estate’s choice of business strategy. The firm’s strategy has been to maintain its internal consistency and to focus on improving the yield of its portfolio of mostly performing assets. The firm’s choice to preserve its organizational status quo—rather than, for instance, restructuring to pursue emerging opportunities—enables it to project an image of stability at a time when it is particularly vulnerable to stockholder and media scrutiny. The perceived stability and financial health of the firm can have an impact on its investment credit rating and on its stock value, especially since life insurers are generally considered to be having real estate problems. In comparison to some of its competitors who are struggling with huge numbers of troubled assets and workouts, and in contrast to a real estate market that is in turmoil, Equitable appears solid.

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11 Interview with the Boston Regional Office Manager, Executive Vice President, Equitable Real Estate Investment Management Inc., Boston, MA, June 17, 1992.
and healthy. Equitable Real Estate is run as an independent business with its parent company, Equitable Life, as its largest client. Headquartered in Atlanta, Equitable Real Estate maintains 14 regional offices, each charged with the responsibility for all general real estate activities within its designated geographic area. Each office must have the functional skills to manage and advise a diversified client base on all types of real estate products and investments. As a full-service investment manager, Equitable Real Estate must be able to approach real estate investments from either the perspective of borrower or lender. Describing the individual regional offices, the head of the Boston office says, "Each office is run like a mini real estate company. We are expected to raise our own capital, invest that capital, manage the investment, and dispose of it. We are each a full-service real estate company." 12

Equitable Real Estate's organizational structure has remained relatively consistent over the last decade. The firm exhibits characteristics of a divisionalized structure with decentralized regional offices that operate as professional bureaucracies. The firm's division of labor is defined by functional disciplines that are vertically integrated between its corporate and regional offices. Each of the firm's regional offices is structurally organized around five functional disciplines:

- **New Business Development** (also referred to as the Production Department) is responsible for identifying investment opportunities for various sources of capital and for preparing financial analyses to support the firm's acquisition and investment decision making processes. This department is also responsible for investigating and outlining the proposed structure of both equity and debt transactions. Technical skills including financial analysis, negotiation, and communication are essential to carrying out this department's responsibilities.

12 Ibid.
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- **Valuation** is responsible for performing appraisals, feasibility studies and market analyses to support the firm's acquisition, disposition, mortgage lending, and portfolio review activities. The valuation department's role is integral to evaluating both proposed new business and existing assets. Appraisal skills (including an MAI or "Member Appraisal Institute" designation), sophisticated valuation expertise, and associated computer proficiency are all necessary to perform the valuation department's functions. In addition, the valuation department is expected to develop and maintain good working relationships with the local real estate brokerage and appraisal communities to cultivate reliable sources of market information.

- **Asset Management** provides investment management services for Equitable's own portfolio of real estate assets. Each asset manager serves as a liaison among owners, investors, property managers, and Equitable technical staff (i.e., appraisers, accountants, financial analysts, etc.). An asset manager's portfolio is client-oriented (centered around owners and investors) rather than property-specific; while other functional divisions may apply their respective technical skills to any property, asset managers work primarily with their own designated portfolio of properties. Asset management is, in this respect, more relationship-oriented than the other functional disciplines.

- **Financial Services** provides the accounting and auditing support required to track and report on operations and investments. Financial Services functions in a controller's capacity to provide budgeting, monitoring, and financial control (i.e., taxes, accounting, collections, and disbursements) to the other divisions.
- **Property Management** is provided by a separate, wholly-owned division called the Compass Group. Compass provides maintenance, leasing and management services at individual properties on a contractual basis. As the group directly responsible for the daily operations at each property, Compass works closely with asset management to provide overall investment management services for both Equitable’s own portfolio and its clients’ portfolios.

Each functional area is set up as its own department with a group leader who reports to the head of the regional office; the regional office manager, in turn, reports to corporate management in Atlanta. The functional disciplines are structurally mirrored at the corporate level and regional discipline heads report to their counterparts at the corporate level. This vertical integration allows each regional office’s work to be reviewed and coordinated on a company-wide basis. For instance, the corporate office can use its macro view to match sources of capital with appropriate investments to build a well-balanced portfolio of assets. The corporate office can also evaluate the 14 regional offices’ individual portfolios to achieve diversification of product and financing structures to mitigate risk.

The firm has decentralized functional responsibilities to give it the ability to manage its real estate investments and relationships on a local basis. Authority and decision making, however, have been centralized in Equitable Real Estate’s home office. The head of the regional office has enough authority to manage his or her office’s functional responsibilities, but the corporate office in Atlanta retains ultimate authority over most major portfolio related decisions. This organizational structure appears to give the home office greater control of financial decisions while allowing it to capitalize on its wealth of local expertise. For example, the regional valuation department might perform an appraisal on a potential investment property using its local contacts and knowledge to establish a current market value. This appraisal is then forwarded to the corporate level.
valuation department (which is staffed with its own team of MAI appraisers) where the appraisal is reviewed for accuracy and depth of analysis. The corporate valuation department either approves the regional appraisal or disapproves it and sends it back to the regional valuation department for revision. Once approved, the appraisal may then be used by the regional office's new business department as it performs its acquisition analysis of a proposed investment and forwards its analysis and recommendations to its corporate counterpart. The corporate new business department uses the regional office's analysis to develop its own recommendation. This recommendation is then submitted to a corporate level conference committee which has the ultimate new investment decision making authority. The vertical integration of functional disciplines, therefore, serves as a key structural element that allows the firm to operate with decentralized responsibility and centralized authority. This structure and operational approach have allowed Equitable to build and manage a relatively sound portfolio of real estate assets. As the real estate market remains highly unpredictable, Equitable seems to be trying to reinforce its sense of internal stability by centralizing authority and decision making to an even greater extent: "There's much more communication and less autonomy now than there ever was," according to the Boston office's regional manager.

The firm's staffing has also remained relatively stable with little turnover or unusual movement of personnel between offices. The trends in personnel additions, promotions and attrition have remained consistent over the last few years, even while the real estate market has become more dynamic and troubled. Many of the individuals interviewed in the Boston office had been with the firm for over 10 years and had acquired much of their professional experience under Equitable's auspices. (One manager interviewed had over 30 years invested with Equitable.) This low incidence of employee turnover may be another factor that contributes to the organization's stability.

At a time when external markets are distressed, it appears that Equitable is primarily concerned with maintaining the status quo of its structure, staffing and
operations. As would be expected, therefore, most of the evidence of organizational learning found at the Boston office took the form of single-loop, error correction learning. Double-loop learning appears to occur much less frequently and is primarily associated with the company’s annual business plan review process. The firm, however, does appear to regularly engage in single-loop learning to carry out its operational functions. For example, as the asset evaluation and investment decision making process has grown more complex over the past decade, the valuation department has had to acquire new financial skills and better technology to keep up with the demand for more sophisticated appraisal analyses:

"We have increased our computer skills and depth of financial analyses over the years. Ten years ago, we used to just crank out numbers on our Hewlett-Packard calculators and do it all by hand. Now we use computers. Our level of analysis and our depth of analysis is greater. Discounted cash flows were used before, but we relied more on direct capitalization in our valuation. Now we always use discounted cash flows." \(^{13}\)

At incremental steps along the way, the company’s information requirements exceeded its valuation department’s ability to provide such sophisticated data on a regular basis. In a simplified sense, there was an “error” in the firm’s ability meet its own information needs. The organization “corrected” this by upgrading its financial analysis standard and by enhancing its technology processing capability:

"I remember when we used to use tables to do our work, using mostly cap rates. Then we used the HP-80 [calculator] to do cash flow analysis, then HP-12’s to do internal rates of return. Now we use computers. The business is much more information intensive now and as we [Equitable Life] demutualize, we will need to provide quarterly performance results to our stockholders." \(^{14}\)

\(^{13}\) Op. Cit., interview with the Vice President, Valuation, June 30, 1992 interview.

\(^{14}\) Interview with a Regional Manager, Equitable Real Estate Investment Management Inc., Boston, MA, June 30, 1992 interview.
Enhancing the firm’s information processing ability to meet growing demands is an example of single-loop learning. The firm’s financial analysis output needed to keep up with industry standards, so the organization made changes in its work processes to maintain its valuation capacity and competence. When the firm corrects other “errors,” such as when it changes the asset mix in its portfolio, increases communications with its clients, or forecloses on a troubled loan, it is making a decision based on this type of single-loop, outcome-oriented learning.

Higher-order forms of learning that require the firm to question its organizational structure, processes and values--its normative behavior--seem to occur much less frequently. Individuals appear to be less concerned with engaging in double-loop or deutero-learning to foster structural change within the organization:

“...If I get a brainwave and think of a new way for the company to get new business, that’s great and I’ll pass it on, but that’s not my principal role.”  

While single-loop learning allows individuals to perform their respective functions and helps the firm to maintain consistency in its operations and structure, double-loop and deutero-learning--and the change they foster--seem to be less of a priority.

Equitable Real Estate does, however, exhibit the potential to engage in higher-order learning. The firm has formalized opportunities for individuals and groups to have access to information and to share information. Bi-weekly staff meetings encourage formal interdisciplinary communication and the sharing of information. Members also spend a significant amount of time listening to and reflecting on the others’ experiences. Information sharing and reflective observation are key steps in the organizational learning cycle.  These regular meetings provide a venue for the type of double-loop

\[15\] Interview with the Vice President, Production, Equitable Real Estate Investment Management Inc., Boston, MA, July 9, 1992.

\[16\] The Lewin Experiential Learning Cycle is presented in greater detail in Chapter Two.
organizational inquiry that can allow the firm to more deeply question its way of doing business and can potentially lead to structural change.

Similar potential for higher-order learning has been created by the firm’s other means of sharing information throughout its decentralized structure. All major portfolio related actions are written up in “executive summary” reports that are forwarded to the corporate office for distribution throughout the company. While these often lead to simple error correction type learning, they do give individuals the ability to assess the firm’s processes, as well as results. The written summaries have the ability to facilitate the type of learning that can lead to changes in Equitable’s normative behavior. In addition, the 14 regional offices have access to loan and property-specific information from any of the other office’s portfolio via a company computer network. While this type of information access is not sufficient on its own to produce higher-order learning, it does contribute to the company’s potential to engage in more meaningful forms of organizational inquiry.

Equitable Real Estate also has potential to engage in higher-order learning at both the regional and corporate levels when it undertakes its annual business plan review. Each regional office assembles a two-year business plan that serves as its operational guide. A regional office plan includes annual budgets, profit and loss statements, and income projections for each functional discipline. The annual planning process requires individuals at various levels and within different functional disciplines to share information. For example, the head of the Boston region coordinates his office’s effort and receives input from each of its discipline heads. His office’s regional business plan addresses the prospects for generating fees from mortgage origination and new business, asset management, asset disposition, and property management (via its Compass group) and makes income projections based on these assessments. The annual business plan review is an “intraspective” process; it requires creative strategizing in which participants are encouraged to come up with ideas for new ways to generate income.
"We might ask ourselves can we do more business with Wall Street? Can we access public funds? Not only can we do it, but how do we do it?"

The corporate office reviews each of the 14 regional business plans and assembles them to build a five-year strategic plan, adding its own budgeting and projections for the third, fourth and fifth years. This comprehensive corporate plan evaluates each of the vertically integrated functional disciplines to identify and track trends in each of the firm's businesses. (Each discipline is thought of as a separate business for this purpose.) This allows the firm to make decisions about whether it should continue to pursue a particular line of business or whether its strategic objectives need to be modified. This process provides the corporate office with an annual opportunity to reflect on operations and to modify its business strategy. It also gives the home office, regional manager and the other discipline heads the ability to do comprehensive, long-range planning that may lead to organizational structural changes. If the loan servicing business, for instance, looks like it may prove to be profitable in coming years, a decision may be made to grow that particular discipline and to devote additional organizational resources to that objective. Such deliberate new business strategizing has recently allowed Equitable to secure loan and portfolio servicing contracts from the RTC. Whether this is indicative of single-loop learning or double-loop learning, however, is not clear. If it represents a fundamental change in the way individuals work together and think, it may be indicative of higher-order learning. If it is simply a way of doing better what the firm already knows how to do, it represents single-loop learning.

Even if these types of business strategizing do represent instances of higher-order learning, they are examples of learning that are occurring on a periodic, irregular basis. Bi-weekly meetings and annual reviews that provide merely the potential for double-loop

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17 Interview with the Boston Regional Office Manager, Executive Vice President, Equitable Real Estate Investment Management Inc., Boston, MA, July 15, 1992.
and deuto-learning do not give the firm the ability to continuously adapt. This, however, does not appear to be one of the firm's goals. Equitable Real Estate has exhibited a preference for maintaining internal consistency and for approaching organizational structural change, not in terms of evolution, but in terms of periodic "quantum" revolution.\textsuperscript{18} While this may give the firm greater stability, avoiding internal change in a dynamic market tends to make the firm more reactive than proactive in nature:

"We tend to respond to changes as they occur, such as changes in regulations or market demand. Sometimes we will target a new business, but the decision to pursue new business is P&L [profit and loss] driven, it's bottom-line oriented. The marketplace dictates that change. ...We try to anticipate change, but the reality is that it occurs internally much closer to when it is happening [externally]."\textsuperscript{19}

Perhaps if the organization was not so dependent on the annual business plan review to engage in its reflective inquiry and learning process, if a more continuous process of double-loop learning took place, Equitable Real Estate could make structural modifications on a more evolutionary and proactive basis. It is not clear from the research that was conducted whether more evolution--incremental change--would make the firm any less stable or would affect its ability to project a solid, financially sound image. Clearly, however, Equitable Real Estate appears to be putting off organizational change as a strategic objective in order to achieve greater internal consistency.

\textsuperscript{18} Refers to Henry Mintzberg's theory of "evolution vs. revolution" in structural reorganization and Daniel Miller's "quantum theory" of structural change as described in Chapter Two of this thesis.

\textsuperscript{19} Op. Cit., interview with the Boston Regional Office Manager, July 15, 1992.
THE TRAVELERS REALTY INVESTMENT COMPANY:

The Travelers Realty Investment Company (TRIC), headquartered in Hartford, is the real estate subsidiary of the Travelers Insurance Company. TRIC's real estate portfolio is valued in 1992 at about $15 billion, 36% of which is considered non-performing. In comparison to other life insurance companies, Travelers has the second highest percentage of non-performing mortgages in its portfolio. (Only Aetna Life has a larger percentage of mortgages that are at least 90 days overdue.) Travelers Realty also leads the industry with 45% of its mortgages in foreclosure. TRIC's Boston office currently manages a portfolio of real estate loans--no equity assets--worth about $500 million. In response to its growing real estate problems, TRIC officially exited the new mortgage business in March of 1991 and has now focused its business on workouts and asset management.

Citing the company's real estate troubles, Moody's Investor Service Inc. and Standard & Poors Corp. both downgraded Travelers' financial strength rating to Baa-1 from A-2 (a two notch drop) in June, 1992. Travelers' rating is now lower than all but a handful of the nation's largest life insurance companies tracked by the investment ratings services. Adding to the firm's problems is the negative media attention it has received over the last year profiling its real estate, credit rating and liquidity troubles. Travelers' real estate problems may be more conspicuous because the company, after it recognized the severity of its situation, appears to have changed its business strategy. Unlike Equitable Real Estate, which has pursued a strategy of maintaining its stability and internal consistency, TRIC has undertaken a series of organizational restructurings. It appears as if TRIC has changed its strategic focus to allow it to foreclose on its

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20 Industry information as of December, 31, 1991, Townsend and Schupp, as reported in the May 18, 1992 issue of National Underwriter.

21 Ibid.


23 Ibid.
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growing number of non-performing loans. This allows the firm to take control of its workout situations and to manage its troubled assets in-house. Asset management, therefore, also seems to be playing a much more significant role in TRIC’s operations.

Travelers Realty’s organizational structure has undergone much change since October 31, 1988 when a workout specialist from Citibank, Allan Schuster, was brought in as the firm’s new president and CEO. TRIC has flattened its hierarchy, closed many of its local offices, and made substantial personnel shifts. In 1988, TRIC had been operating 15 separate field offices and several regional offices that served as intermediaries with the corporate office in Hartford. In March of 1990, what has been referred to as “the big shake-up” occurred and all of the regional offices were eliminated:

"The choice was either to give more authority to the regional offices or to do away with them. The move to centralize was an effort to consolidate the regions and to allow more direct reporting and better communication to support the home office’s decision making. With the elimination of all of the regional offices, we removed an entire level of bureaucracy and flattened out our hierarchy."[24]

Several of the field offices were also closed over the next year and the remaining local offices were functionally reorganized into four disciplines:

- **New Business** originated new real estate loans and consisted mostly of loan officers with the requisite financial skills and lending experience.
- **Investment Recovery Group** (IRG) took responsibility for working with troubled loans and investment assets.
- **Asset Management/Property Management** managed the firm’s growing REO portfolio and took care of daily operations, maintenance and leasing at these properties.
- **Property Sales** marketed REO assets and sold properties both directly and through brokers.

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The real estate markets, however, continued to decline and by March of 1991, more changes were necessary. TRIC stopped making new real estate loans and the new business department personnel was absorbed into the rest of the organization. (Travelers continues to make purchase money mortgages to buyers of its REO assets.) The Investment Recovery Group (IRG) was transformed into the Investment Management Recovery Group (IMRG) in recognition that TRIC’s biggest long-term challenge would be to manage its expanding portfolio of troubled loans and equity assets.

TRIC is now organizationally structured to operate on a decentralized basis with field offices that exhibit the characteristics of a professional bureaucracy. The firm’s division of labor is organized around functional generalists who must be proficient in a range of technical and professional skills (i.e., financial, legal, analytical, and property management skills). These functional generalists report to both a local office manager and to a corporate office executive; this dual line of reporting helps to vertically integrate TRIC’s decentralized structure. Travelers Realty appears to be continuing the centralization of its field operations and has plans to close additional offices, eventually moving all non-corporate functions to only five local units in Dallas, Los Angeles, Chicago, Hartford, and Atlanta. Loan portfolios are still being managed on a regionally decentralized basis through these offices, but control and authority for most other functions, including relatively low-level administrative functions, has been centralized. The Boston office, for example, currently consists of a relatively small IMRG team, with an office manager, three account officers who each handle a separate portfolio of loan and workout accounts, two investment administrators who function as support staff for the account officers, and two real estate coordinators that do secretarial work. While functional responsibility is decentralized throughout TRIC’s local office operations, the firm appears to be centralizing authority to an even greater extent. All financial and portfolio related decisions are made at the corporate level and even some of the administrative authority is being centralized. The head of the Boston office, for instance,
supervises only the three other account officers; the two investments administrators and two real estate coordinators are managed from the Hartford office.

More strategic changes will lead to additional modifications in TRIC’s organizational structure. The New England region’s asset management and REO portfolio are now located in the Hartford office. The Boston office currently has no asset managers since its entire portfolio consists of debt assets. Travelers is expecting to increase the number of troubled loans on which it will foreclose in a strategic move to take control of its workout situations.25 To prepare for this challenge, TRIC plans to move its regional asset management department to the Boston office on November 1, 1992. While most functions are becoming more centralized, effective asset management depends heavily on local relationships and market knowledge. Moving this function out of the Hartford office, therefore, may give the asset managers better management capabilities.

Travelers Realty appears to have been impacted by the downturn in the real estate markets. Part of its response has been to restructure its organization and, as offices were reorganized or closed, this restructuring effort appears to have included a high incidence of personnel moves and turnover. For instance, Travelers went outside of its own organization to bring in a workout specialist, Allan Schuster from Citibank, to help reorganize TRIC. This appears to have set the tone for the firm’s restructuring. After the real estate markets had started to deteriorate and TRIC’s Boston office began to experience large-scale trouble in its loan portfolio, three different office managers were brought in within the course of an 18 month period. Similarly, of the four investment managers in the Boston office, only one has been there since Allan Schuster took over the firm in 1988. Personnel turnover is another example of the organizational restructuring that has been taking place at TRIC.

25 Interview with the Vice President and Manager of the Boston Office, Travelers Realty Investment Management Inc., Boston, MA, July 13, 1992.
This continuing series of structural and strategic changes appears to have been undertaken to allow Travelers Realty to redeploy its organizational resources to better accommodate its workout and asset management focus. This continuing series of incremental adaptations may be even more significant if it indicates that Travelers has learned to employ a more evolutionary approach to its process of making organizational change. A more continuous approach to instituting organizational change, however, is dependent on the firm’s ability to engage in higher-order forms of organizational learning.

Most of the evidence of organizational learning found at the TRIC’s Boston office took the form of single-loop, error correction learning. Double-loop learning appears to occur much less frequently and is primarily associated with the company’s annual portfolio review process. The firm exhibited some possible evidence of deutero-learning, but it is unclear from the data gathered whether this highest-order form of learning (“learning to learn”) is occurring. The data did show, however, that individuals at TRIC engage in outcome-oriented single-loop learning almost daily as they perform their respective functions. Loan officers recommend adjustments to keep healthy loans from becoming troubled, property managers adjust spending to keep within budget, and sales staff adjusts property prices to reflect changing market conditions. Each of these examples represents a simple learning process that allows decisions to be made that maintain the status quo. Through this type of “error correction” inquiry, the firm only learns to do better what it already knows how to do. But to grow and evolve organizations must look inward and engage in a higher-order reflective inquiry process that allows them to question their fundamental values and normative processes.

Top management instituted an annual portfolio review process in 1989 that requires each office to assemble an assessment of the real estate assets in its respective portfolio. This was to be done in addition to a quarterly Investment Review Process (IRP) that reported on the status of each loan in the local office’s portfolio. Since its
inception, the portfolio review appears to have become one of the more comprehensive organizational assessment tools used by TRIC to detect “errors” in its operations. Each office is able to reflect on its previous year’s achievements and failures:

“...It’s a chance for us to take a break from putting out fires and catch up on all current business. We get a macro view of where we are and where things are going.”

As a whole, the firm seems to devote substantial resources to this annual effort. Each office spends about two full weeks assembling its respective portfolio review, suspending all but the most urgent regular business, and then makes a presentation to top management from the corporate office. The process appears to foster significant single-loop learning as errors are detected and corrected. For instance, a summary status of each loan is presented to the corporate office. If the performance of the loan or workout situation is below standard, the corporate office has the opportunity to make changes or suggest a new approach to dealing with the troubled asset.

The annual portfolio review requires substantial amounts of information. Each office’s portfolio review now includes a detailed description of all loans and assets, a summary of market conditions, and a status report on operations that goes into such detail as to include biographies of each staff member. More than being a way to brief management on the financial status of each office’s portfolio, the review serves as an information sharing venue that has the potential to foster higher-order types of learning. This process allows TRIC to take the time on an annual basis to reflect on its operations, including both its structure and strategy. In this sense, the annual exercise is not only a “review,” but has the potential to be a more proactive “planning” process.

Robert Waterman, in his book The Renewal Factor, sums up the importance that the planning and review process can play in helping companies to engage in reflective learning.

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26 Interview with an Investment Manager, Travelers Realty Investment Company, Boston, MA, July 9, 1992.
inquiry. He calls those firms that are able to question their fundamental organizational processes “renewers”:

The process of planning has multiple purposes; for many the process was more important than the plan itself. While poking good-natured fun at some of their own past plans that went awry, the renewers seem to know how important the process can be in generating information, in identifying issues, in improving communications, in reinforcing the culture, in supporting the financial control system, and in identifying possible crisis spots.27

TRIC’s annual portfolio review gives the firm and its individuals the ability to come to know their roles and their limitations better. Through this process, the organization has the opportunity to focus on itself as much as its portfolio; individuals are given the opportunity to reflect on the firm’s way of doing business, its normative practices:

“We get to see how the entire office is functioning and get to ask questions like, ‘Are people jelling?’, ‘How are people working together?’, and ‘Is there good teamwork?’.”28

These are the types of reflective questions that can give the firm the ability to move beyond simple single-loop, error correction learning. In the planning sense, the firm’s annual portfolio review has the potential to foster double-loop learning and to be a powerful catalyst for organizational change.

Information sharing and reflective inquiry are necessary elements in the organizational learning process, and similar potential for error correction and higher-order learning appears to exist in the firm’s other means of sharing information throughout its decentralized structure. A company-wide computer network links all of the local offices via the corporate headquarters. Information on an asset in any of the firm’s local office portfolios can be accessed “with 25 keystrokes of my computer.”29

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28 Interview with a Vice President, Travelers Realty Investment Company, Boston, MA, July 9, 1992.
29 Interview with an Investment Manager, Travelers Realty Investment Company, Boston, MA, July 9, 1992.
The corporate office will also fill a request for asset information within 24 hours. In
addition, all local and corporate staff meeting minutes are written up an circulated to each
of TRIC’s offices. These kinds of information sharing devices give individuals the
opportunity to access data that may add to their own limited sphere of experience. An
asset manager in one office, for instance, might find a more effective approach to
handling a troubled asset by reading another office’s staff meeting minutes or accessing
asset performance data via the firm’s computer network. In addition, these types of
information sharing vehicles give the firm the ability to track trends in its operations and
to get a more comprehensive understanding of how staff members are working together.
While these types of opportunities may simply lead to more error correction, they do
contribute to Travelers Realty’s potential to engage in higher-order forms of
organizational learning. The firm’s enhanced information sharing capabilities, therefore,
have the potential to bring about additional organizational inquiry and structural changes.

Since 1988 the firm has undertaken a continuing series of changes in its
organizational structure that appear to give it the ability to more effectively manage the
large numbers of troubles assets in its portfolio. Flattening out its hierarchy, redeploying
its resources, and enhancing its information sharing and planning processes seem to have
given TRIC the ability to better focus its business on workouts and asset management.
As the firm has made these incremental changes over the past few years, it may have
become more proficient in the reorganization process itself. Workers appear to be more
comfortable with the organizational restructuring strategy, the relatively high rate of
personnel turnover, and the somewhat unpredictable nature of the continuing
reorganization process:

“Our mission is clear and well-communicated from the top.
We are flexible and creative, and I have a good understanding of
the framework in which I can conduct my business.”

30 Interview with the Vice President and Manager of the Boston Office, Travelers Realty
If this more evolutionary process of change has made individuals at Travelers Realty more proficient at managing organizational learning and continuous change, the firm may be engaging in deutero-learning, or the process of “learning to learn.” More research data collected over longer periods would be necessary to conclusively determine whether individuals at TRIC are engaging in this highest-order form of organizational learning.

It does appear, however, that Travelers Realty’s organizational restructuring strategy has allowed it to take a more proactive approach to dealing with the large numbers of troubled assets in its portfolio. In anticipation of an increase in the amount of REO property in its portfolio as it accelerates the rate of foreclosures on its non-performing loans, the firm already has plans to move its regional asset management office to Boston. As TRIC becomes more proactive, as opposed to being merely reactive, it may be able to gain more control over its troubled assets--despite the dynamic condition of the real estate market. The firm may have begun its reorganization efforts in response to its troubles, but now, rather than trying to maintain internal consistency in its operations, TRIC appears to have made organizational change a strategic priority.
The Boston offices of Equitable Real Estate Investment Management Inc. and the Travelers Realty Investment Company (TRIC) represent two institutional investment firms from the same industry that appear to be pursuing different business strategies. Equitable Real Estate, with only 6% of its assets classified as non-performing, has chosen to maintain its internal consistency and to focus on improving the yield of its portfolio of mostly performing assets. Equitable’s choice to preserve its organizational status quo allows it to project an image of stability while its parent company is in the process of demutualizing to raise additional capital. Travelers Realty, in contrast, with 36% of the investments in its real estate portfolio classified as non-performing, has undertaken a strategy of restructuring its organization to allow it to more effectively manage its workouts and troubled assets.

One possible explanation for the difference in these two firms’ organizational strategies is that each needed to pursue a different business focus. With few troubled assets and no workouts in its portfolio, Equitable Real Estate’s Boston office describes its biggest challenges as asset management and new business production. Travelers Realty, on the other hand, has had to focus on primarily workouts and asset management. (TRIC officially stopped making new real estate investments in 1990.) Travelers has had to make a more dramatic shift in its business focus which may have given it a greater need to reorganize its resources. Such reorganization is necessary because the same technical skills that a real estate investment firm uses to produce new business must be employed in a different way when it undertakes workouts and asset management:

"Workouts are like ‘reverse production.’ The same disciplines needed to originally structure a deal and create value are required when those creations have to be put back together." ¹

¹ Interview with the Boston Regional Office Manager, Executive Vice President, Equitable Real Estate Investment Management Inc., Boston, MA, June 17, 1992.
Travelers had the requisite skills, but appears to have felt compelled to make structural changes that would allow it to more effectively deploy its organizational resources. Restructuring may have allowed TRIC to reorganize its technical skills to better approach its "reverse production" effort.

Both firms exhibited similar organizational structures with decentralized professional bureaucracies and vertically integrated functional divisions. Equitable’s division of labor, however, was defined by functional disciplines (five separate departments), while Travelers used functional generalists in its field offices. These organizational structures seem to have been inherited from past incarnations of each firm’s real estate operations. While Traveler Realty has made a series of structural changes, neither firm appears to have fundamentally questioned its organizational design in light of the downturn in the real estate market. Further research might answer whether a completely new organizational design would be more effective than a modification of either firm’s established structure.

After a series of structural changes and personnel moves, Travelers Realty appears to have increased its organizational tolerance for change. Its Boston office has adapted to an environment in which a relatively high rate of personnel turnover and office reorganization is now the norm, almost to be expected. Equitable Real Estate, on the other hand, has provided its staff with a more stable environment. Future data on both firms’ portfolio performance might reveal whether a greater tolerance for change can give an institutional real estate investor a competitive advantage in a highly dynamic, unpredictable real estate market.

Higher-order forms of organizational learning may also be able to give institutional real estate investors a competitive advantage. “Learning organizations” have the ability to make changes on a more evolutionary and proactive basis. While neither Equitable nor Travelers exhibited explicit evidence of deutero-learning, both firms appeared proficient in the error correction type of single-loop learning and both seemed
to be able to periodically engage in double-loop learning. Of the two companies, Travelers appeared to have greater potential to undertake higher-order forms of organizational inquiry on a more frequent, but still inconsistent, basis. TRIC’s annual portfolio review was more participatory and gave individuals throughout all levels of the firm’s organizational structure the opportunity to collaboratively share information. Equitable’s annual business plan review required input from all functional disciplines, but interdisciplinary collaboration did not appear to be a central element in its organizational planning process. Interactive feedback and collaboration are key parts of the four-stage learning cycle and TRIC’s greater organizational information sharing capabilities may give it greater potential to foster organizational learning. These learning characteristics appear to be making the firm more proactive. TRIC shows signs of being able to make proactive organizational changes, while Equitable has remained primarily reactive in its organizational response to changing market conditions.

• CONCLUSIONS:

The analyses presented in this thesis offer suggestions to those institutional real estate investment firms that are looking for ways to deal more effectively with their troubled assets in a volatile market. The following are some conclusions and recommendations:

• Be more proactive in your approach to making organizational change:

It appears that the institutional real estate investment firms that have experienced the most trouble also have had the greatest motivation to make organizational change. Firms with large numbers of troubled assets may feel compelled to initiate organizational change in order to redeploy their existing skills and resources to focus on workouts and asset management. Other troubled firms may simply find themselves in a crisis management mode and may make structural and strategic changes just because the status quo is unworkable. In this sense, trouble seems to beget change.
“Pain” may be great motivation for organizational change, but why wait until it hurts to learn to adapt? Those institutional real estate investment firms that have relatively few troubled assets in their portfolio have more of a choice. They can choose to continue their relative “success” by maintaining consistency in their organizational strategy and structure, and by merely learning to do better what they already know how to do (i.e., engage in single-loop learning). Alternatively, these firms could choose to use their relative success as an opportunity to devote organizational resources to making proactive changes that may allow them to seek and pursue emerging opportunities and may ultimately give them a competitive advantage. While allowances must be made for other business considerations, all institutional real estate investors should understand that stability and organizational consistency can only be short-term strategies in a market that is by its very nature highly dynamic. An evolutionary approach to organizational change can help even successful firms avoid unintentional obsolescence.

- Encourage employees at all levels to participate in a regular organizational planning process:

Annual planning (or “review”) processes create regular opportunities for individuals and groups to share information and to engage in single-loop and potentially higher-order forms of organizational learning. Equitable Real Estate has used its increased communications capability to primarily engage in single-loop, error correction forms of organizational learning. Individuals at all levels of the firm do not engage in a reflective form of organizational inquiry that calls into question the firm’s fundamental organizational practices and values. While this strategy has enabled Equitable to weather the current real estate crisis with greater stability and consistency in its operations, it must be wary of falling into a classic “competency trap.” When market conditions improve, the firm’s future ability to compete and succeed may require an organizational strategy that is more proactive with respect to change. A firm must be able to identify future opportunities and must be able to avoid potential pitfalls. Those firms that make the
effort to engage in higher-order forms of organizational learning can develop the ability to evolve and to better understand and take advantage of changing market conditions:

They assume opportunity will keep knocking, but it will knock softly and in unpredictable way. Their ability is to sense opportunity where others can't, see it where others don't, act while others hesitate, and demur when others plunge.²

Information sharing, however, is a necessary, but not sufficient element to foster higher-order organizational learning. Even Travelers Realty, which has instituted an annual portfolio review process that is much more participatory and gives virtually all of its staff access to important organizational information, does not appear to regularly engage in double-loop or deutero-learning. Organizational learning may be a more complex process that also requires such things as continuous sharing of information, reflection, interactive dialog, collaboration, creativity, and the license to fail.

*Expect a healthy level of failure:*

Firms that are committed to evolution and learning encourage their workers and managers to use their own initiative, to be creative, to collaborate, and to experiment. Organizations that strive to achieve the greatest learning ability in order to achieve long-term objectives must be willing to make mistakes along the way. They must be ready, therefore, to expect a healthy level of failure during the ongoing organizational process of learning and change. In other words, it might take a few tries to get it right or to find that better way. Short-term “failures” can often lead to long-term success.

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Chapter Four

- Learn to evolve and “learn to learn”:

The firm that waits to restructure until external markets force such change upon the organization may be allowing its productive capacity to suffer for extended periods. A firm may be compromising its long-term success for short-term stability and consistency when it opts for revolution over evolution. Firms can learn to evolve in order to maximize their productive potential. Evolution, or continuous adaptation, is dependent on a firm’s ability to engage in higher-order types of learning. Those institutional real estate investors that engage in double-loop learning and deutero-learning continuously question and refine their organizational strategies and structures.

Learning, therefore, is a complex means of changing and renewing organizations. Those institutional real estate investors that look for simpler answers will find only a quick fix. Long-term solutions require thought, effort and action—a description of the organizational learning cycle itself. In a world of constant change, learning and evolving are more important than simply surviving. All institutional real estate investments firms, including those that are relatively healthy and those that are troubled, can choose to take control of their destiny:

“Dreams, not desperation, move organizations to the highest levels of performance. Our dream ought to be institutions that work for, not against, our needs. That is the hope, the power, the dream, and the challenge in renewal.”

Those organizations that inspire their employees to learn and to become better learners have the best chance at realizing their collective potential.

A firm must be able to adapt to changes in its work and environment to meet whatever unexpected challenges may arise. An organization must be open to change and its members must be allowed—even encouraged—to question their most fundamental work

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3 Ibid., p. 312
processes and collective behaviors. More than simply being problem solvers, individuals must engage in a process of learning that calls into question the very norms and structure of their environment. If there is a better way, they must be allowed to search for it, to invent, to experiment, to risk failure, and to engage in a richer learning process that allows them to continuously re-create their organization. This higher-order learning has the potential to produce innovation and those firms that truly understand the potential benefits, both in terms of human achievement and competitive advantage, will facilitate the learning process. They will actively encourage their members to learn and to become better learners.
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