2017 BDO RISKFACTOR REPORT FOR REITS

2017 BDO RiskFactor Report for REITs

2017 is leaving a string of broken stock market records in its wake. Since hitting the 20,000 mark for the first time days after Donald J. Trump's inauguration, the Dow Jones Index has climbed past 21,000, and NASDAQ surpassed 6,000. REITs have seen more modest boosts in performance, registering 3.41 percent growth for the year as of June 2 compared to the broader S&P 500's 9.91 percent gains.

Competition for assets at lucrative prices, the anticipation of tax reform and the likely drumbeat of interest rate hikes through the rest of 2017 could be peppering the market with uncertainty and serving up unappetizing borrowing cost increases for REITs.

"After enjoying several years of growth following the economic crisis, investors are beginning to take a more cautious approach. A potential slowdown in the market, combined with concerns of rising interest rates, a lack of continued access to capital, and disruptions in several REIT sectors, has added to the uncertainty. For REITs navigating the current economic environment, there is a real possibility this confluence of factors may result in slower growth."

Stuart Eisenberg, partner and national leader of BDO's Real Estate and Construction practice

Top Risk Factors

cited by 100 largest publicly traded U.S. REITs

RISK FACTOR CITED IN 10-K FILING	2017		2016		2015	
General economic conditions, including disruptions in the financial markets	#1	100%	#1t	100%	#1t	100%
Access to capital, financing and liquidity	#1t	100%	#8t	96%	#3t	99%
Failure to qualify as a REIT	#3t	99%	#1t	100%	#1t	100%
Federal, state and local regulations	#3t	99%	#5t	98%	#10t	93%
Environmental liability	#5t	98%	#4	99%	#12t	92%
Interest rates & hedging	#5t	98%	#5t	98%	#6t	97%
Natural disasters, terrorism and geo-political events	#5t	98%	#7	97%	#14t	92%
Industry consolidation & competition for lessees	#8t	97%	#1t	100%	#5	98%
Financial covenant restrictions	#8t	97%	#8t	96%	#8t	95%
Tax laws & rate increases	#8t	97%	#12t	94%	#3t	99%
Insurance risk & uninsured liabilities	#11t	96%	#8t	96%	#8t	95%
Indebtedness	#11t	96%	#8t	96%	#12t	92%
Capital improvements/renovation costs	#11t	96%	#14	93%	#17	88%
M&A, joint ventures and partnerships	#14	95%	#12t	94%	#6t	97%
Cybersecurity breaches	#15t	92%	#15	91%	#16	89%
Anti-takeover & change of control provisions	#15t	92%	#19	85%	#18	82%
Illiquidity of real estate investments	#17	90%	#16	88%	#10t	93%
Credit risk	#18t	86%	#17	87%	#19t	80%
Construction permits, costs and abandonment	#18t	86%	#18	86%	#19t	80%
Bankruptcy & property foreclosure	#18t	86%	#22	80%	#19t	80%
Declining values & asset impairment	#21	84%	#23	79%	#22t	78%

**t indicates a tie in the rankings*

CHANGING OF THE GUARDS: REITS ADJUST TO THE TRUMP ADMINISTRATION

REITs are preparing for legislative, regulatory and tax changes under the nation's 45th President, with tax and healthcare reform topping the list. More than one-quarter (26 percent) of the REITs analyzed mention Trump's name a total of 59 times in their 10-K filings. Forty-four percent reference the new administration—and the resulting uncertainty—as a risk factor.

>1 in 4 REITs
mention **Trump** by name

Among those 26 REITs, **Trump's name** was mentioned
59 times

44%
list concerns related to the **new administration**

REITS LOOK TO EXPAND HORIZONS

Risk related to portfolio diversity spiked this year—with 72 percent of REITs citing geographic concentration as a risk, compared to 60 percent last year. REITs may be looking to further diversify their portfolios and broaden their investment horizons in 2017. While more than half (56 percent) of REITs point to impediments to U.S. expansion as a concern, that risk is down slightly from 63 percent last year.

72%
cite **portfolio diversity**, up from 60% last year

56% cite **impediments to US expansion**, down from 63% last year

CHOPPY INTERNATIONAL WATERS

International real estate markets—including Canada, Europe, India and New Zealand—are home to many attractive investment opportunities, but capitalizing on opportunities abroad comes with risk. Fifteen percent of REITs raised concerns related to the United Kingdom's vote to leave the European Union (Brexit) last year. Complying with international legislation, regulations and any changes to how the US taxes repatriations could also prove challenging.

38%
identify **international operations** risk

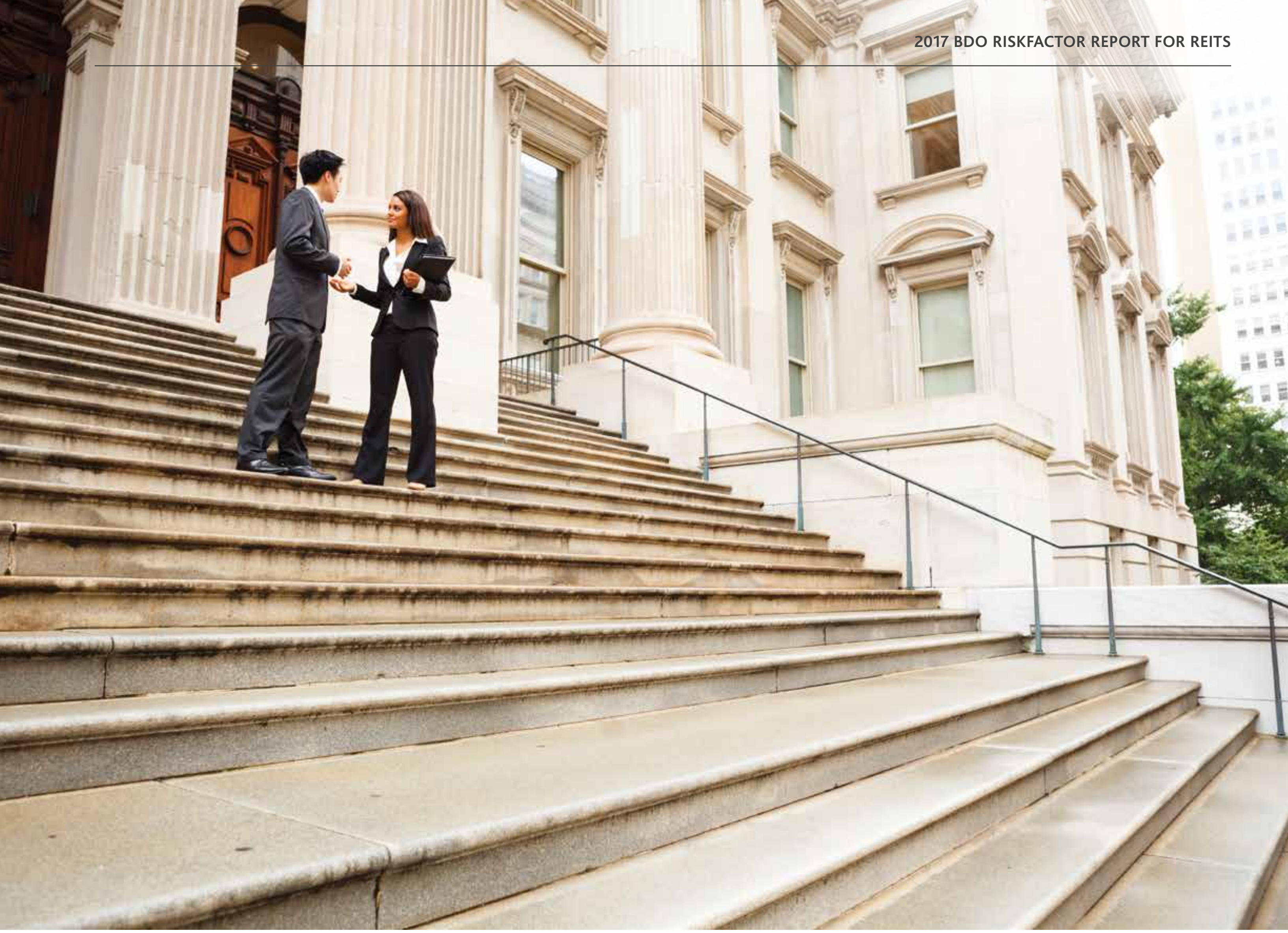
30%
reference **foreign currency risk**

18%
cite **impediments to international expansion**

15%
reference **Brexit**

"Now that Brexit negotiations are underway, REITs with properties or investments in the U.K. are gearing up for what's ahead—with a keen eye on any changes to trade or regulatory policies. It remains to be seen how the negotiations will play out; uncertainty still reigns supreme."

Russell Field, national head of BDO U.K.'s Real Estate and Construction practice



Hold on to Your Hats: Regulatory, Tax & Accounting Changes Accelerate

After a tumultuous 2016 general election cycle, risks tied to the installation of the new presidential administration are cited by more than 4 in 10 REITs (44 percent).

Some elaborated, pointing to resultant shifts in legislative and regulatory priorities that could have a material effect on their business. Among those mentioned specifically? Travel restrictions, tax reform and the ongoing efforts to repeal and replace the Affordable Care Act.

Beyond these high-profile initiatives, regulatory, tax and accounting changes that could impact REITs' operations are already underway—and REITs are taking note in their disclosures to shareholders.

REGULATION

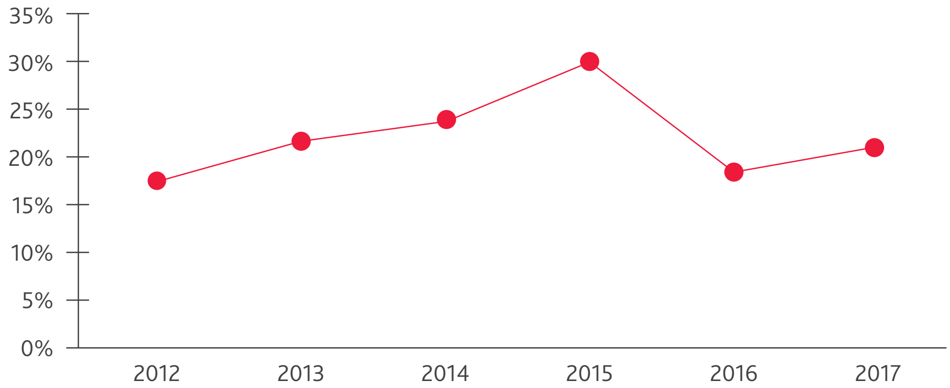
Nearly all REITs analyzed cited federal, state and local regulations (99 percent) and environmental liability (98 percent) as a risk to their operations, consistent with our analysis year-over-year. While much of the dialogue around regulation in prior years has focused on a tightening regulatory belt and mounting costs of compliance, there appears to be a turning of the tides toward a more pro-business current under the new administration.

For example, more than one in five (21 percent) REITs mentioned the Dodd-Frank Wall Street Reform and Consumer Protection Act in their disclosures, a slight uptick from 2016 but still lower than 2013 to 2015 levels. One of President Trump's stated campaign

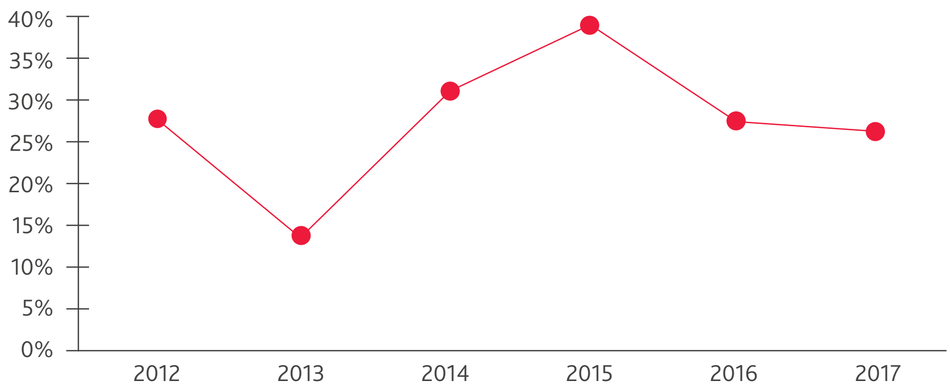
pledges was to repeal Dodd-Frank and the administration appears keen to fulfill that promise of regulatory easing. In early May, the House Financial Services Committee voted to send the Financial CHOICE Act—which would roll back significant pieces of Dodd-Frank—to the House floor, where the bill passed this June. In a letter to committee Chairman Jeb Hensarling, R-TX, Real Estate Roundtable President and CEO Jeffrey D. DeBoer cited the act as an opportunity "for balanced reforms of a number of burdensome Dodd-Frank provisions affecting real estate," including credit risk-retention and other rules impacting "real estate credit capacity, liquidity, capital formation and job growth."

On the incentives side, 26 percent of REITs cite changes in government programs as a risk, notably down from 39 percent two years ago. One key change that could signify a shift toward a more favorable environment for real estate developers and owners was the revival of New York's 421(a) developer tax abatement, renamed Affordable New York, as part of the state's $163 billion budget. Key changes in this revival from the version of 421(a) that expired in 2016 include wage requirements for construction workers on certain projects, as well as a longer break from property taxes (35-year break, as opposed to 25-year break in the previous version) on large projects that pay those wages.

DODD-FRANK WALL STREET REFORM & CONSUMER PROTECTION ACT



CHANGE IN OR LOSS OF GOVERNMENT PROGRAMS & INCENTIVES



TAXATION

With tax reform on the table—and the White House's initial tax framework announced—REITs are simultaneously assessing the impact proposed reforms could have on their business models and implementing changes to comply with IRS requirements going into effect at the end of the year.

Proposed Tax Reforms High on REITs' Radar

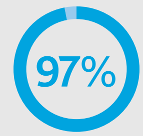
Among the changes proposed in the White House's tax reform framework and the GOP's initial tax reform blueprint, the following are top of mind for REITs:

- Elimination of corporate alternative minimum tax (AMT)
- Limitations to interest deductibility and net operating loss (NOL) deductions
- Reductions in corporate tax rates
- Alterations to the tax treatment of carried interest
- Changes to the current depreciation deductions
- Elimination of 1031 exchange, or the "like-kind" exchange
- Changes to the repatriation tax rate on profits held overseas

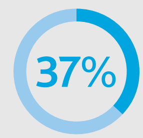
Of key concern are the provisions that could alter rules related to REITs' tax status and have a material impact on their taxable income. With tenants spanning diverse industries, REITs' fiscal health can also be sensitive to tax changes affecting tenants' operations. As the future of tax reform still hangs in the balance, REITs are closely watching how proposals develop.

Immediate Tax Changes: PATH Act

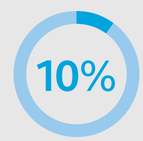
Of more immediate concern for REITs is a key provision of the Protecting Americans Against Tax Hikes (PATH) Act which has an implementation deadline for taxable years beginning after Dec. 31, 2017. Under the new guidance, the value of all taxable REIT subsidiaries (TRS) and non-real estate assets cannot exceed 20 percent of the value of the REIT's total assets. This is a departure from prior guidance, which set the threshold limit at 25 percent.



cite risks related to **tax laws and rate increases**



referenced the **PATH Act**, up from 10% last year[1]



mentioned the new partnership taxation audit rules under the **Bipartisan Budget Act of 2015**

1 Methodology changed. In 2016, the analysis included only specific mentions of the PATH Act. In 2017, the analysis included mentions of specific provisions of the Act as well.

"REITs are particularly focused this year on what those changes under the PATH Act mean for their businesses. To prepare for the new requirement, REITs will need to divest some of their assets housed in TRSes or other non-real estate assets, without sacrificing tenant services to maintain a competitive advantage relative to other properties."

Jeff Bilsky, partner in BDO USA's National Tax Office

"REITs may think the lease accounting and revenue recognition standards won't significantly impact them, but they may be surprised. Applying the new standards can be complicated, and organizations that aren't making headway on an adoption plan—establishing it and putting resources behind it—risk falling behind."

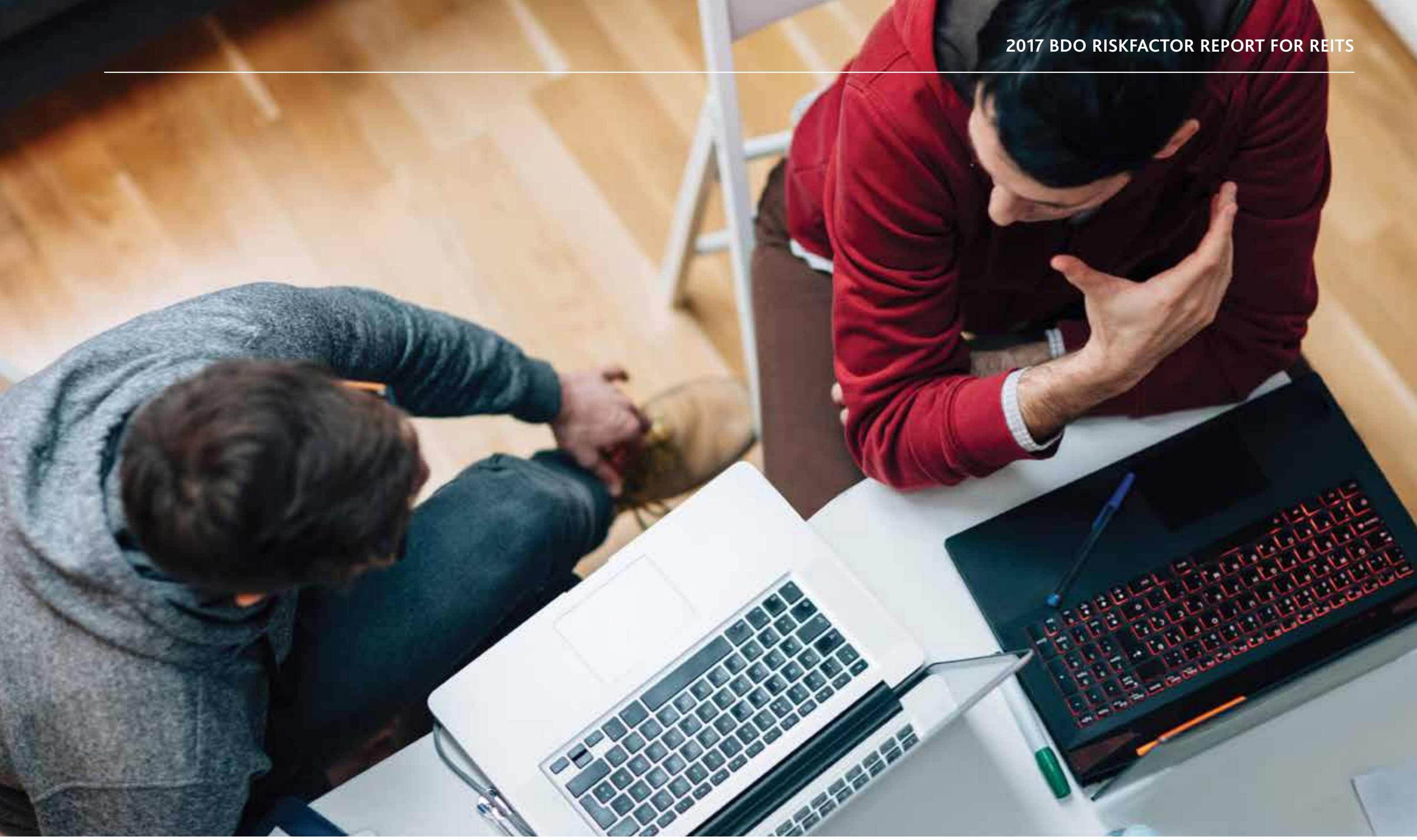
Angela Newell, national assurance partner

REITS UNDERESTIMATE LEASE ACCOUNTING AND REVENUE RECOGNITION

Internal controls and financial reporting risks and accounting rule changes are cited by 71 percent, up from 69 percent in 2016 and 50 percent in 2014. One accounting standard update that's particularly key for the commercial real estate industry is the newly finalized Lease Accounting Standard, ASC 842, from the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB), which will take effect in December 2018.

But just 15 percent of REITs specifically noted lease accounting in their filings, consistent with 2016 levels (14 percent). While the rule isn't expected to change accounting practices for lessors on its face, there will be implications around ground and equipment leases. And lessors should be aware of the steps lessees may consider taking to manage their own balance sheets. REITs may also need to consider the impact on non-Generally Accepted Accounting Principles (non-GAAP) financial metrics that they report in shareholder letters and earnings releases.

REITs are also paying attention to the interaction of the lease accounting standard with ASC Topic 606: Revenue from Contracts with Customers (revenue recognition), which goes into effect for public companies in 2018 and non-public companies in 2019, with early adoption available this year. Depending on the sector, the new standard may impact how rental income and other related charges, including common area maintenance reimbursement, are recorded, as well as when a sale of real estate should be recognized.



Tech & Cybersecurity: A Whole New Ball Game for REITs

Technology risk has been a persistent thorn in REITs' sides, as operational and competitive threats penetrate every segment of the real estate market.

From an operational perspective, REITs' reliance on their information systems and technology has grown significantly. Ensuring the right systems are in place and keeping them in working order are top priorities in 2017. Almost 3 in 4 REITs (72 percent) cite operational risks associated with the implementation and maintenance of technology and systems, consistent with prior years.

CYBERSECURITY RISKS INTENSIFY FOR REITS

With greater reliance on technology comes increased cyber risks, and more than 9 in 10 REITs (92 percent) identify cybersecurity as a threat in their disclosures, up from just 25 percent in 2012.

The May 12 [WannaCry ransomware attack] stands out as just one example of how cyberattacks can spread like wildfire across industries and international borders. The ransomware program hit organizations around the world, including an estimated 3,300 infections in North America.

A variety of cyber threats, including phishing scams, ransomware attacks, distributed denial of service (DDoS) and permanent denial of service (PDoS), could wreak havoc on REITs. Recent strides have been made by the industry—to automate processes, install Internet-connected equipment and devices into properties, and transition management and accounting software to the cloud—that have introduced a host of new cyber risks. Furthermore, the threat of attack doesn't end with REITs' own IT systems: Threat actors can exploit vulnerabilities that lie with REITs' tenants or third-party vendors, managers or franchisors.

"The biggest cybersecurity mistake companies can make is underestimating the likelihood of an attack. In the end, what will separate REITs from their competitors is how well they're prepared to handle a breach when the inevitable incident hits. Developing a cyber risk management strategy now will pay dividends when companies are faced with live threats in the future."

John Riggi, Head of BDO's Cybersecurity and Financial Crimes Practice

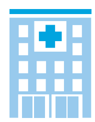
WHICH TENANTS ARE HACKERS TARGETING?

Hackers can exploit valuable data from virtually any business, but certain industries—like healthcare—are prime targets for cyberattacks. The industry houses highly valuable bulk datasets of patient health records, personally identifiable information and payment information, as well as connected medical devices. It's no surprise that healthcare REITs unanimously identify data breaches as a risk.

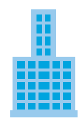
Cyber is a concern in the retail and hospitality sectors as well: All retail REITs and 93 percent of hospitality REITs cite cybersecurity as a risk in their 10-K filings. Hackers often target credit card processing and point of sale (POS) systems to steal credit card information. While most hospitality REITs have cybersecurity on their radar, the data suggests they could be underestimating it still. According to Verizon's 2017 Data Breach Investigations Report, the accommodation industry—which encompasses restaurants as well as traditional hospitality players like hotels—experienced 201 data breaches in 2016, over half of which were POS breaches.

CYBERSECURITY RISKS BY REITS' INVESTMENT FOCUS

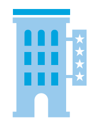
100% RETAIL



100% HEALTHCARE



96% OFFICE



93% HOSPITALITY

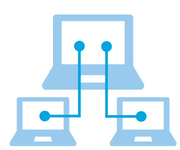
92% MULTIFAMILY

THERE'S AN APP FOR THAT: THE GIG AND SHARING ECONOMY

Startups like Airbnb, WeWork and Breather are bringing the sharing economy to the real estate sector, leaving a wave of disruption in their wake. Whether it's a platform for services, deliveries, ride-hailing or home- and office-sharing, most share certain key features, including transparent ratings systems and in-app payments. The name of the game has become instant gratification: Space sharing and growing demand for shorter-term commitments are shaping the future for the retail, hospitality, office, apartment and timeshare sectors.

NO VACANCY: WHAT DOES DISRUPTION LOOK LIKE FOR HOSPITALITY REITS?

80% point to the **sharing economy and online rental platforms**



80% cite the growing popularity of **third-party Internet intermediaries**

73% cite loss of **franchise license**

Four out of five hospitality sector REITs (80 percent) cite the growing popularity of third-party intermediaries—like Travelocity and TripAdvisor—as a risk to their business. Most said the biggest risk posed by these service providers was an impact on brand loyalty. Instead of booking accommodations directly with a hotel brand, many travelers now turn to travel sites to price-check their options and peruse reviews and ratings making it more difficult for hotels to build brand loyalty.

Eighty percent point to the sharing economy and the proliferation of online rental platforms like Airbnb and VRBO as a threat to their business in the year ahead. This year, several jurisdictions—including New York City—introduced laws regulating online rental platforms. To counter scrutiny and solidify the platform's legitimacy, Airbnb prioritized establishing tax agreements with 275 jurisdictions, including 5 countries and more than 30 states.

"Disruptive players in the lodging industry pose a unique set of challenges for hospitality REITs. Unlike REITs focused in other segments, maintaining strong brand loyalty among their customers is a key priority. While rental sharing platforms continue to attract travelers, large, well-established hotel brands have maintained a strong foothold. As the data reflects, maintaining franchise licenses is one of the crucial components for hospitality REITs' continued success."

Anthony La Malfa, partner in BDO's Real Estate and Hospitality practices

E-COMMERCE ACCELERATES, BRICK-AND-MORTAR RETAILERS ARE WARY

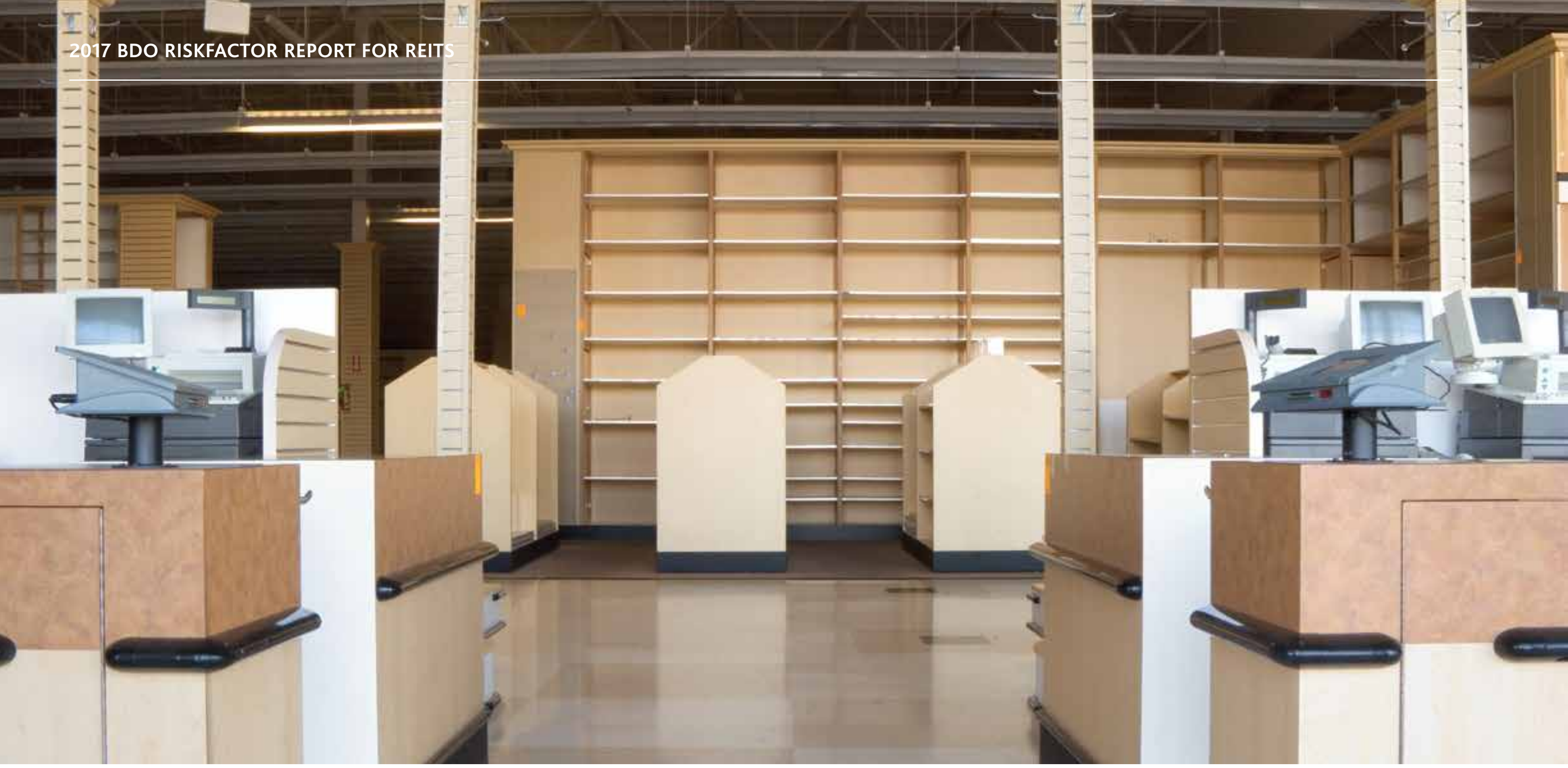
REITs operating in the retail industry are keeping a close eye on the rapid growth of e-commerce as it transforms business models and shifts emphasis away from brick-and-mortar stores. Unsurprisingly, more than three-quarters of retail REITs identify e-commerce as a threat to their bottom line.

76%
of retail REITs point to the **growth of e-commerce** as a threat

E-commerce M&A transactions totaled
$17B
in 2016, up from $10.51B last year, according to BDO's [Current State of E-Commerce Report]

"Brick-and-mortar retailers are facing the incredible growth of e-commerce head on. Strategic acquisitions—like Walmart's purchase of Jet.com—are a smart play for traditional retailers to stay in the game. Retail REITs are keeping a close eye on how their tenants adapt their business models to remain competitive with these emerging market pressures."

Natalie Kotlyar, leader of BDO's Consumer Business practice



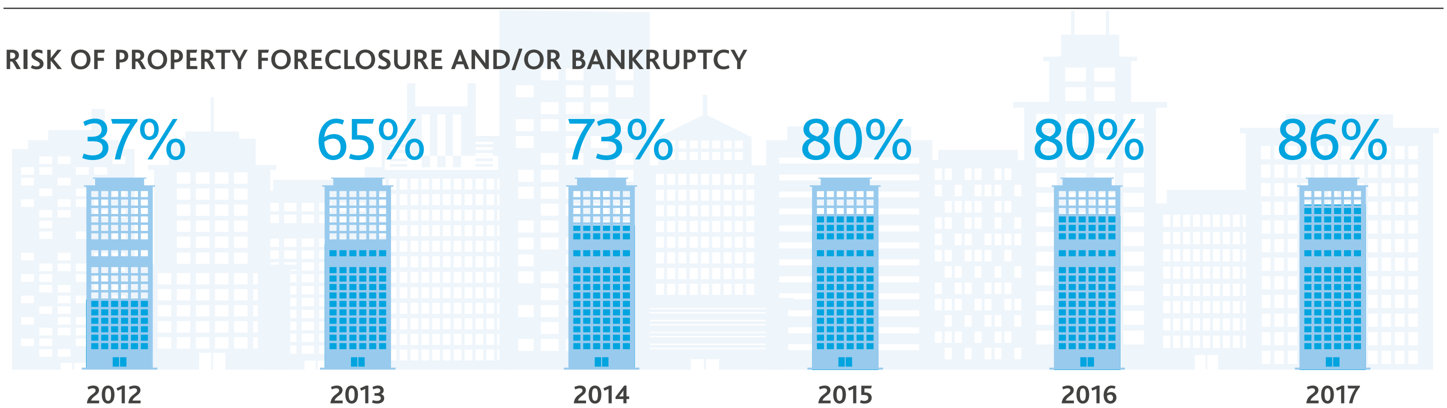
Capital Scarcity and Falling Real Estate Values High on REITs' Risk Radar

After the Federal Reserve kicked off its long-awaited rates hike program in December 2016, REITs are bracing for the impact of multiple interest rate increases and evaluating their ability to effectively hedge their debt.

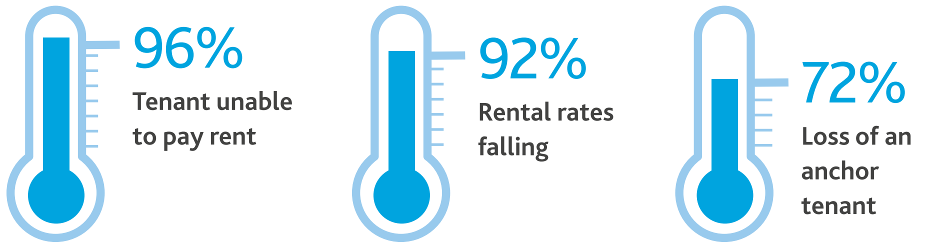
Higher costs of debt and equity could also strain retailers and other tenants that have benefited from the low interest rate environment and the availability of cheaper debt. Nearly all REITs (98 percent) cite interest rate increases—and their ability to hedge against them—as a risk to their strategies this year. Uncertainties over inflation are also on the rise this year, with 52 percent of REITs listing it as a risk to their business in the year ahead, up from 42 percent in 2016.

Inflationary pressure and interest rate worries are likely being driven by growing concerns about tightening capital markets and potential declines in real estate values and lease rates across several REIT sectors. The top 100 REITs unanimously cite access to capital, financing and liquidity as a risk to their business, up from 96 percent in 2016 and 93 percent in 2014. This year also saw a meaningful jump in the number of REITs (86 percent) that listed bankruptcy and foreclosure as a risk this year, up from 80 percent in 2016, and 37 percent in 2012.

RISK OF PROPERTY FORECLOSURE AND/OR BANKRUPTCY



TAKING THE TEMPERATURE OF RETAIL TENANTS



Worries about credit risk is also growing among the top 100 REITs. Most (86 percent) cite credit risk, which represents a meaningful jump from 55 percent in 2014 and 38 percent in 2013. Financing and transactional concerns among REITs appear to be reflected in the broader commercial real estate market, which is showing signs of further slowing in 2017 after several bull-market years. According to a recent report by Scotsman Guide, the industry saw a 31 percent drop in deal activity between February 2016 and 2017. That followed double-digit year-over-year declines in both December and January as well.

MACRO-LEVEL ECONOMIC TIGHTENING EXACERBATES SECTOR-SPECIFIC REIT CHALLENGES

As the economy begins to show signs of uncertainty at the macro-level, several REIT sectors are facing a unique set of challenges for growing their business on a micro-level. For example, among residential REITs, 83 percent worry tenants could be unable to pay rent and 100 percent list falling rental rates as a top concern. It's notable that increased worries over tenant solvency is consistent across all REIT sectors this year, whether commercial or residential. Four out of five REITs (80 percent) cite tenants being unable to pay rent as a risk to their business in 2017, up from 71 percent in 2012. Furthermore, nearly all (96 percent) REITs say their business faces risks related to indebtedness this year, up from 75 percent in 2014.

Retail REITs, however, are facing the biggest economic challenges, largely due to the rise of e-commerce. Retail REITs face even bigger challenges as both malls and brick-and-mortar retailers are seeing significant cuts to consumer demand and asset valuation. Among retail REITs, 96 percent cited their tenants' ability to pay rent as a risk in 2017, while 72 percent said the loss of an anchor tenant was a risk for their business.

Many of America's malls have seen dramatic valuation cuts in the last several years. In one example, a mall in Kingston, New York saw its valuation drop to $8.1 million in December, down from $87 million in 2010. And retailers aren't fairing much better. A March article in the USA Today started with the question: "Is 2017 the death of retail as we know it?" It went on to list more than a dozen national retailers that had, at the time, announced more than 3,300 store closings. Concerns over the future of the brick-and-mortar retail model were raised again in May after several national retailers, having missed their first quarter earnings estimates, saw their stock prices tumble.

But despite recent headlines touting retail's demise off the back of Q1 earnings, there is a silver lining for the industry. Some high-end mall REITs have begun to find success in moving up-market to fill vacancies created when struggling retail chains have moved out, as well as by cultivating a differentiated shopper experience by incorporating more entertainment, activity and dining venues. These developments indicate the retail model, while changing, is far from dead, which should bolster REITs operating in the sector and willing to innovate.

While REITs face their fair share of challenges in the current market environment, strategic investments could be the key to staying above the fray. With the stock market continuing to reach record-heights, REITs broke a record of their own this year. According to NAREIT, publicly listed REITs raised more than $23.1 billion in equity and debt in the first quarter of 2017—the most capital raised in any quarter since 2014. REITs that take proactive measures to address changing market conditions, prepare for cyberattacks and plan for interest rate increases, will likely be well-equipped to take these risks in stride.

The ***2017 BDO RiskFactor Report for REITs*** examines the risk factors in the most recent 10-K filings of the largest 100 publicly traded U.S. real estate investment trusts; the factors are analyzed and ranked by order of frequency cited.

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