INSIGHTS FROM THE BDO REAL ESTATE & CONSTRUCTION PRACTICE

REITS CONTENDING WITH FLEXIBLE LEASE DEMANDS

By Stuart Eisenberg

This year is poised to be an eventful one for REITs, with several regulatory and policy changes taking effect that will impact operations and balance sheets.

These changes—coupled with a real estate business cycle that many executives feel is at or past its peak, according to findings from ***BDO's Global REIT Report***—present a mixed bag for REITs in the new year.

As **I wrote last year**, REIT executives' expectations have been tampered, but they remain overall confident for the near-future. The most recent and long-term change for REITs is the much-anticipated, new lease accounting standard that took effect at the beginning of the year for most public companies after it was first announced in 2016. For private companies, the new standard will begin in 2020.

Now that the new standard is officially here, I've outlined immediate takeaways and potential long-term impacts.

IMMEDIATE IMPACT TO YOUR BALANCE SHEETS

The new standard was designed to increase transparency and comparability across organizations that lease buildings, equipment or other assets by explicitly laying out all assets and liabilities that arise from any lease transaction. Previously only required for capital leases, the new standard now mandates all operating leases to be included in an organization's balance sheet at the present value of future lease payments. In many cases, lease obligations on balance sheets will represent the largest asset and liability a company holds. The uncertainty as to how the large liabilities will be viewed by the investment community and lenders is of concern to both landlords and tenants.

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CATALYZING THE SHIFT TOWARDS FLEXIBILITY

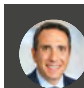
The rapid growth of WeWork and other coworking space providers has made short-term and flexible office leases more widespread. As major corporations follow startups and freelancers and embrace shorter leases, traditional landlords will increasingly expand their own flexible offerings to remain competitive. The new lease accounting standard provides an added incentive for tenants to demand shorter leases.

Beginning in 2019, more tenants will likely seek to restructure their leases or sign new leases with shorter terms. While tenants favor flexibility, the shift introduces uncertainty for landlords. Landlords are unlikely to reduce the length of leases to the shortest time periods offered by coworking companies, but landlords will need to make compromises to remain competitive.

Additionally, lenders may be less willing to provide long-term financing for shorter leases on commercial properties, which would complicate budgeting and planning for owners of commercial properties.

BDO'S OUTLOOK FOR 2019

The lease accounting standard is just one of many changes that REITs are contending with in 2019. By continuing to monitor both the immediate and long-term impact of these regulatory changes, REITs can position themselves to successfully navigate the shifting landscape this year and beyond.



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