

THE NEWSLETTER OF THE BDO REAL ESTATE INDUSTRY PRACTICE

REAL ESTATE MONITOR



MICRO-APARTMENTS

By John Tax

A micro-apartment is generally considered to be a one-room, self-contained living space. It is designed to accommodate sitting and sleeping spaces, a bathroom and a kitchenette, and it usually occupies between 150 and 370 square feet.

In population-dense cities such as New York, Washington, D.C., and Chicago, the demand for such spaces is growing. However, builders face unique design challenges in making these smaller units appealing to prospective tenants. In order to develop these apartments, builders must balance efficient use of space, contend with handicapped and zoning regulations, while at the same time making the units energy-efficient and aesthetically appealing.

Micro-apartments rentals should flourish with multiple trends driving growth such as:

- Household formation skewed toward the growth of 1-2 person households;

- “Walkability” of area of development;
- Financial pressure leading the search for lower rents;
- Constant demand for well-serviced and eco-conscious units and
- Reduced units available.

One benefit of such high-density housing is that these developments can slowly grow a neighborhood without government attempts to develop an area with major, disruptive projects. Neighborhoods should realize that new construction adds value by providing more demand and inducement for local amenities (i.e., restaurants, shopping, etc.), which provide a benefit to all residents in the area.

In lieu of new construction, rehabilitation of older buildings may be another avenue worth investigating. An alternative to new construction may be rehabilitation of existing, larger units. This type of

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MICRO-APARTMENTS

development avoids excessive planning, approvals, delays and, ultimately, monetary investment. It also means less neighborhood disturbance and resistance.

The benefits to tenants are a well-connected location at a low rent while the builder/operator can make more rent per square foot than with larger units. Owners providing services upfront, such as high-speed data and out-of-unit storage, further enhances the appeal of such developments. However, priority should be given to the two most important factors:

- **Location** – since most tenants put a higher value on external amenities, the location for a micro-apartment development must be close to shopping, restaurants, services and transportation and
- **Competition** – the developer must be cognizant of surrounding vintage stock, single-resident occupancies and senior housing since micro-apartments will only comprise a limited portion of the market.

An investor should always be aware of the environment it is building in. Neighborhoods can become over-built and any type of commercial development has limits. However, good design, forethought and anticipation of location and construction can pay off with higher incomes and greater values for micro-apartments.

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SINGLE-FAMILY REITs POISED TO SUCCEED

By Carla Freeman



Despite initial uncertainty surrounding the long-term viability of the single-family REIT sector, it has enjoyed strong momentum, and investors have shown an appetite for this asset class. The sector emerged from the 2008 credit crisis, when many investors were able to buy bundles of foreclosed and real estate-owned homes at large discounts. However, because many single-family REITs formed amid a struggling economy and housing industry, this business model will now need to transition from the portfolio acquisition phase into the portfolio maintenance phase as the economy stabilizes and individuals return to the marketplace.

The time for single-family REITs to prove that they have staying power may be here. The S&P Case-Shiller 20-City Home Price Index shows that home prices are currently near post-recession highs. The U.S. Census Bureau underscores this trend, recently stating that homeownership rates in the second quarter continued to trend lower, to 64.7 percent, down from 65 percent at the same time last year and 69.2 percent in 2004. As homeownership declines demonstrate the consumer's preference for rentals, the potential for growth and sustainability in this sector will bode well.

Rising national home prices impact not only potential homeowners but single-family REITs seeking to acquire new assets. As such, many single-family REITs whose initial approach was to acquire properties in bulk, irrespective of geographic location, are now developing more geographically focused strategies. This

can allow them to scale internal property management platforms and move away from outsourcing contractors and maintenance staff, which can create operational complexities and decrease overall profitability. Successful implementation and execution of large-scale in-house property management platforms focused on key geographic hubs will be critical in creating sustainable profitability.

Many single-family REITs are also now turning to securitizations to meet their funding needs. A securitization is a structured financial instrument, similar to a mortgage-backed security, where a pool of properties serves as collateral for the bond while interest payments are secured through operating cash flows from those properties. The investor receives a risk-adjusted rate of return on its investment while knowing he or she has an investment in a high-credit-rated debt. Although seemingly complex, securitizations can offer companies reduced cost of debt, which frees capital to fund growth.

While it remains to be seen how the single-family REIT sector will fare in the long term, many industry players are very active and seek to capitalize on current market opportunities.

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REAL ESTATE LOAN AGREEMENTS: LENDER PROTECTIONS

By Anthony La Malfa

►THE BALANCING ACT

A properly structured real estate loan, or any loan for that matter, must strike a balance between the objectives of both borrower and lender. A real estate loan that fails to achieve this balance may be overly onerous for one party or both parties and could prove unsustainable over the long term.

At a basic level, real estate borrowers approach the financing of income producing property with the goal of maximizing returns (i.e. minimize their borrowing costs) while maintaining flexibility. On the other side of the table, real estate lenders also seek to maximize returns while protecting their investment. In order to accomplish their objectives, lenders generally include protective provisions and covenants within the loan documents.

►LOAN PROVISIONS

There are a myriad of provisions and covenants included in real estate loans designed to protect lenders and mitigate specified risks. Some of the more common provisions and covenants include loan-to-value (LTV), debt service coverage and break-even ratio thresholds as well as recourse and third-party guaranties. One provision that had been gaining some traction in loan agreements is "resizing."

This provision protects the lender from declines in the underlying collateral by requiring that the loan not exceed a specified maximum LTV throughout its term. (LTV is generally calculated by dividing the outstanding debt by the market value of the collateral property.) The resizing provision generally allows the lender to revalue the collateral property at any time during the period over which the loan is outstanding.

This lender protection comes at the expense of the borrower who will be required to make up the shortfall in the LTV in accordance with the terms of the loan agreement. The loan agreement may require an immediate equity contribution by the borrower, may allow for subordinated



financing or may provide for some other cure over a predetermined time frame.

In his June 2012 *Real Estate Finance* article, "Resizing Provisions in Commercial Real Estate Loan Agreements," Douglas Buck calls attention to this rarely used but significant new loan provision. Although this provision has not received a significant amount of attention, it has surfaced in commercial real estate loan agreements from time to time and generally seems to be utilized more by middle market lenders.

►NEGOTIATING THE PROVISION

The resizing provision serves to meet the objectives of the lender. Borrowers, especially in secondary and tertiary markets, and borrowers without strong track records may find it difficult to have these types of provisions removed. The general goal of the borrower in a situation where the provision cannot be removed is a focus on increasing the maximum LTV ratio, thereby lessening the effect of negative market conditions, and limiting the lender's right to revalue the property. Another area of borrower focus in this situation is generally the interest rate. Loans with resizing

provisions should carry lower interest rates to account for the additional protection afforded the lender by the borrower.

►LOOKING FORWARD

As resizing provisions have the potential to be particularly burdensome for borrowers, a loan without a resizing provision is clearly preferable. However, if a resizing provision cannot be removed, borrowers would ordinarily take steps to mitigate this risk and better structure other provisions of the loan to improve real estate investment returns.

On the part of the lender, resizing provisions should be carefully considered before being included in a loan. The resizing provision may be a valuable tool to protect the loan principal, especially on loans with heightened risks. Conversely, it may be the impetus for a borrower to walk away from a property at the worst possible time.

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REAL ESTATE OPTIONS

By Gregory Klemchek

AN OPTION AGREEMENT IS AN EXTREMELY VERSATILE INVESTMENT TOOL THAT COMES IN A VARIETY OF FORMS AND CAN BE USED FOR A VARIETY OF PURPOSES.

The primary virtue of an option is that it gives the optionee (the party holding the option) potential control over property (in the sense of the right to acquire it) for a small initial cash outlay. In effect, it achieves a very high degree of flexibility and conserves cash, two goals sought by both real estate investors and real estate speculators. Real estate options offer a low-cost, low-risk alternative to investing in real estate and are often used by real estate developers as well as investors in commercial properties and high-end luxury homes.

An option provides its holder the privilege, but not the obligation, to buy a specific parcel (or series of parcels) of real estate, at a specified price, on specified terms within a fixed period, which often can be extended. The person who grants the option (the optionor) agrees to refrain from selling the property to any other party during the option period in exchange for consideration, which the optionor will keep whether or not the option is exercised by the optionee. Typically, an optionee may also assign or sell its rights in an option to a third party unless it is specifically prohibited in the contract terms of the option.

►TYPES OF OPTIONS

Under a fixed price option, the price for the underlying property is a predetermined fixed dollar amount that does not change during term of the option. Under a step-up price option, the price for the underlying property increases by designated amounts at designated times within the option period. Under a step-down price option, the price is reduced by designated amounts at designated times during the option period.

The option also may be described in terms of how the option price is structured. Most common is the no-credit option, under which the optionee receives no credit against the purchase price of the land if the option is exercised. Under

full credit option, the price paid for the option itself is fully credited against the purchase price of the optioned property.

►PURPOSES OF USING OPTIONS

In addition to being classified in terms of its features, an option may be classified in terms of its purpose. The purpose or objective of using options can be distinguished as follows:

The first purpose of using an option is to maintain control over a parcel of land in the expectation of new developments or legislation that will make the land more valuable or suitable for a particular use without the risks and obligations of direct ownership of the land. The objective of this type of option could be used to provide control of the land over a relatively long period of time in the expectation of appreciation in the value of the property. This type of long-term option can be used during a period of depressed market conditions, when owners often are pessimistic about future appreciation. A speculator might then obtain a long-term option at a low price (both in terms of the option fee and the price for the land itself).

Another purpose for using an option may be to combine an assemblage of separate parcels of land into a single parcel. A developer putting together an assemblage normally is interested in acquiring all or none of the parcels. Consequently, in order to avoid committing large amounts of capital to a project that may not succeed, the developer will proceed with options rather than purchase contracts. Each contract could be conditioned upon acquisition of the remaining parcels, but this would reveal the assemblage plan and cause an immediate rise in prices of the parcels not yet acquired.

A landowner who suspects that an assemblage is in process may insist on a most favored purchaser clause before giving the option so

that it is equal (on some comparable basis) to the highest price paid for any other parcel. Because the developer may be confronted by one or more holdouts and be forced to sharply increase the exercise price for them, this type of clause can substantially increase the gain to earlier optionors.

►OTHER REAL ESTATE TRANSACTIONS

Other real estate transactions may take different legal forms but accomplish similar economic objectives as compared to options. An option may be compared to (1) a contract of sale with a liquidated damage clause; (2) a sale with a nonrecourse purchase money mortgage; and (3) a lease containing an option to purchase.

►CONTRACT OF SALE WITH LIQUIDATED DAMAGE CLAUSE

Instead of acquiring an option, which would require an option fee that can be credited against the purchase price upon exercise of the option, an investor may enter into a formal contract of sale containing a liquidated damage clause. A liquidating damage clause would provide the investor the right to walk away from a contract to purchase real estate, subject only to the loss of the down payment.

►PURCHASE MONEY MORTGAGE

As an alternative to taking an option, an investor may purchase the land, acquiring legal title from the seller who takes back a standing (no amortization) purchase money mortgage equal to 100 percent of the sales price, with interest to be paid annually. The mortgage is nonrecourse (the buyer having no personal liability), so the seller's sole remedy in the event of a default in payment on the loan and interest is to repossess the land. If the purchase is of undeveloped land and the mortgage contains a provision for the release of individual parcels, the mortgage functions in the same manner as a rolling option. The cost of purchase money mortgage financing typically requires the buyer to pay a higher rate of interest compared to traditional bank financing.

Perspective in Real Estate



The seniors housing industry is headed for another boom time, driven by growing demand, improved transparency into financials and opportunity for portfolio diversification. Further, easier access to capital is facilitating construction and turnaround investment.

While few large deals are available and the barriers to entry can be high for those unfamiliar with the space, those playing within it are seeing strong returns on their investments. Cap rates for health care properties are currently about two percentage points higher than the average yield on an office or apartment building, according to data cited by *The Wall Street Journal* in September.

A summer 2014 survey by the *National Real Estate Investor* (NREI) and National Investment Center for the Seniors Housing & Care Industry (NIC) found that 49 percent of the 233 commercial real estate respondents expect the volume

of seniors housing property sales to increase in the coming year, with only 5 percent anticipating a decline in sales.

The seniors housing industry weathered the financial downturn better than most real estate sectors: seniors housing and care properties were the only real estate class to increase rent growth during 2009, according to the NIC. Now, the improving residential real estate market is enabling additional seniors to sell homes and move into seniors housing communities, and this combined with the general aging of the population is helping to fuel demand. (Of note: the seniors housing industry includes independent and assisted living and memory care facilities, but not skilled nursing facilities.)

Further, memory care construction is taking off; NREI states that three of four current seniors housing and low-acuity health care construction projects include dementia care units. According to the Alzheimer's

Association, a billion people worldwide will require memory care by 2050.

However, only a few large senior living portfolios exist in an industry with many small players. In the second quarter, only three of 77 transactions exceeded \$100 million, according to NIC MAP data, and the median transaction size was \$9 million, posing a challenge for private equity firms seeking to join a space with strong competition. Those who do manage to take a noticeable slice of the pie are seeing substantial investment gains. In 2012, three private equity firms bought an 80 percent stake in Sunrise Senior Living's management unit for \$130 million. They exited the investment in April 2014 to the tune of \$400 million, a fivefold investment gain that included a \$101 million dividend, according to *Bloomberg News*. The market is trending toward similar percentage gains in the foreseeable future.

Perspective in Real Estate is a feature examining the role of private equity in the real estate industry.

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REAL ESTATE OPTIONS

►LEASE WITH OPTION TO PURCHASE

A third alternative to the use of a straight option is a lease containing an option to purchase. In this arrangement, the investor can obtain immediate possession of the property as a tenant, paying rent rather than an option fee. A lease with option to purchase transaction is common for income-producing property. The investor is in a position to earn a return over and above the rent paid to the landlord while at the same time retaining the right to acquire ownership of the land at a future date. Similar to a straight option, this type of transaction can provide the investor

with additional returns upon appreciation of the property over the lease term.

►CHOICE OF TRANSACTION

In determining which type of transaction is best, the parties must pay attention to the factors that the IRS uses to distinguish a sale, a lease and an option for tax purposes. For example, if the option fees are disproportionately large compared to the exercise price of the option, the IRS might characterize the entire transaction as an installment sale, under the theory that the optionee would in all events

exercise the option because of the amounts already paid. Consequently, if the seller wishes the payments to be treated as true option fees, the seller may be forced to accept lower payments than desired.

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