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THE NEWSLETTER OF THE BDO REAL ESTATE INDUSTRY PRACTICE

REAL ESTATE MONITOR

BDO REAL ESTATE PRACTICE

BDO's Real Estate practice consists of multi-disciplined professionals, well-versed in compliance and consulting matters. Our professionals have many years of experience in financial reporting and accounting, tax and auditing issues and are continually updating their knowledge and, therefore, are dedicated to giving timely and accurate advice.

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COMMERCIAL REAL ESTATE – WHERE ARE WE HEADING

By Anthony La Malfa

An investment in commercial real estate, as with any investment, is a bet on future events and circumstances. Since the value of the acquired property can change if its location's demographics and economy shift over time. That's why it is critical to determine at the start of your search how much and where to invest in order to hedge your real estate bet.

There are certain basic factors that real estate investors generally consider when assessing the viability of an investment in a specific property or region. A proper assessment of these factors will result in a determination of where to invest and what type of property to invest in.

TIME HORIZON

One of the factors to consider is the investment time horizon or holding period. Over time, as we'll discuss later, markets change and, therefore, so will investment returns. The investment strategy will dictate the holding period and will lead investors to specific markets. For example, an investor may be willing to accept higher risk and may be looking to capitalize on a hot and growing market over a shorter holding period. Conversely, a more risk averse investor may be looking for steady cash flow from a more established market over a long-term holding period.

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COMMERCIAL REAL ESTATE

URBANIZATION

The holding period assessment naturally leads to a number of other factors to consider, such as continuing urbanization around the world. Urbanization, the population shift from rural to urban areas, has a significant impact on the prospects for commercial real estate. Urbanization doesn't affect all urban areas equally and some urban areas grow faster, and sometimes significantly faster, than others. (In fact some urban areas shrink over time, but we'll save that for another article.)

In addition to growth rates, the physical growth of urban areas (i.e., horizontal or vertical growth) differs depending on a number of factors, but most importantly available land.

Urbanization factors will dictate the types of properties that will perform better in a given market at and over a given time period. For example, high-rise office and multi-family buildings combined with street-level retail will generally out-perform in quickly growing vertical cities whereas office parks and destination malls and power centers would perform better in cities with moderate horizontal growth.

DEMOGRAPHICS

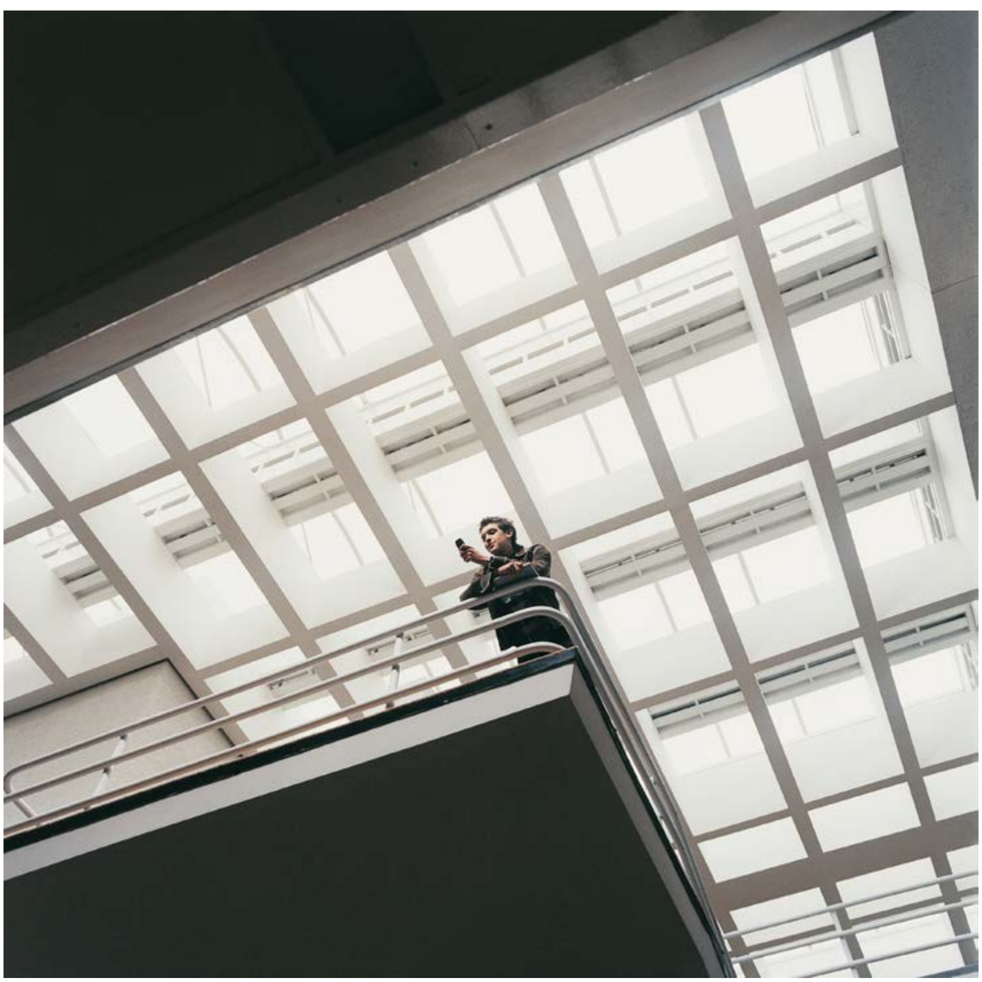
The sibling, maybe more of a cousin, of urbanization is demographics (defined as the quantifiable statistics of a given population at a point in time). Similar to the manner in which urbanization has an effect on market and property type, demographics and projected demographic shifts also play a role.

Factors such as education levels, income levels, age and family composition, have a specific impact on the types of properties that will perform in a given market. Markets with younger populations with growing families (think multiple kids) would warrant different retail and healthcare properties than those with older populations. Similarly, markets with higher education or skill rates would warrant different commercial properties than those with lower or more unskilled labor populations.

MARKET SATURATION

Another key factor to consider is how saturated a given market is currently, or is projected to become. Put another way: how quickly vacancy in a given property type will be absorbed by a given market. Market saturation is of particular importance to real estate developers or those looking to re-develop or re-purpose an existing property.

Overall, commercial real estate investors (and developers) generally seek properties in markets that will be able to better absorb the available space or that will benefit over time from the factors discussed above. Of course there are always exceptions to the consensus, especially when looking at trophy properties and "international" or "gateway" cities.



MAKING THE INVESTMENT DECISION

As one seeks to make an investment in commercial real estate and searches for the perfect property and market, the key is developing a reasonable prediction of future events and circumstances.

In his recent article in the National Real Estate Investor, *Looking Backward, Looking Forward, The Evolution of Commercial Real Estate*, David J. Lynn provides some insight into the history of commercial real estate investing and, more importantly for our purposes here, certain future global trends relating to urbanization and demographics. These trends are clearly important to commercial real estate investing; specifically to identifying the appropriate market and property type to achieve the investment objectives within the investor's specific time horizon.

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ALTERNATIVE PROPERTY TYPES FOR REAL ESTATE INVESTORS

By John Tax

WHEN AN INVESTOR LOOKS TO INVEST IN REAL ESTATE THE TYPICAL CLASSES OF SUCH INVESTMENTS ARE: OFFICE, RETAIL, MULTI-FAMILY, INDUSTRIAL AND HOTEL.

In recent years, however, investors are finding more specialty real estate products into which to deploy their capital. These atypical investments include the following:

FARMLAND

Farmland has always been a lucrative commercial property investment. In January 2013, Gladstone Land Corporation (Gladstone) became one of the first publicly traded farmland real estate investment trusts (REITs). Gladstone invests in farmland and farm-related properties throughout the United States. Farmland Partners, Inc. is another farmland REIT available for investors who are interested in this type of real estate.

TIMBERLANDS

Another type of real estate asset is timberlands. Companies that own and manage timberlands generally own huge tracts of land whereon they can harvest trees and convert the raw materials to building products. One of the largest timberland REITs is Plum Creek Timber Company which owned approximately 6.8 million acres of timberlands in the United States as of December 31, 2013. Other timberland REITs include Rayonier, Inc., Weyerhaeuser Company and Potlatch Corp.

BILLBOARDS

While not immediately apparent, billboards and other out-of-home advertising structures (e.g., advertising displays in municipal transit systems) are also considered to be real property. In fact, on April 16, 2014, CBS Outdoor America Inc. (CBS) received a private letter ruling allowing it to convert to a REIT. A company similar to CBS is Lamar Advertising Company (Lamar) which is another publicly traded REIT. Lamar owns over 145,000 billboards and is considered the largest outdoor advertising company in the United States.

INFRASTRUCTURE

Through public/private partnerships investors can invest in infrastructure assets such as airports, tunnels, toll roads, gas networks, bridges, education facilities, etc. A REIT that is involved in this real estate segment is Hannon Armstrong Sustainable Infrastructure Capital, Inc. (Hannon). Hannon provides debt and equity financing for sustainable infrastructure projects that deploy cleaner energy sources such as solar, wind, geothermal and natural gas. Hannon also owns land and other physical assets used in sustainable infrastructure projects.

DATA CENTERS

As technology's presence in our daily lives increases, more of our data is kept in the "cloud." In spite of its name, however, the "cloud" requires millions of square feet of physical space to store all of this information, with millions more slated for construction in the coming years. Digital Realty Trust operates a publicly traded REIT solely for those investors interested in this type of real estate.

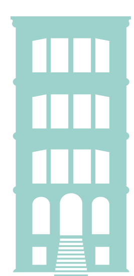
SELF-STORAGE UNITS

With the decrease in single-family purchases and the increase in apartment occupancy levels there has been an increased need for self-storage properties throughout the country. Revenues and occupancy levels for such facilities are growing by double digits, according to research firm Marcus & Millichap Real Estate Investment Services. There are a number of public REITs that invest solely in this type of real estate, such as Extra Space Storage, Public Storage and CubeSmart to name just a few.

SINGLE-FAMILY HOMES

In place of home ownership there are an increasing number of families renting single-family homes. A number of REITs have been started in the past few years that buy and rehab single family homes and lease them out. These REITs would include American Residential Properties, American Homes 4 Rent and Silver Bay Realty Trust Corp.

STUDENT HOUSING



A lucrative property niche that has emerged post-recession is student housing. With state-run schools facing fund cuts for on-site housing, private developers have stepped in to deliver premium off-campus facilities to satisfy the current generation of students. One such REIT that specializes in this type of real estate is American Campus Communities Inc. (ACC). ACC became a REIT in 2004 and currently manages 167 properties with more than 102,000 beds in approximately 33,000

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ALTERNATIVE PROPERTY TYPES

units. Another such REIT which owns this type of real estate is Education Realty Trust, Inc.

MEDICAL OFFICE BUILDINGS

As the Affordable Care Act takes effect, an asset class likely to grow is medical office buildings. With health care systems throughout the country seeking to provide more localized, lower-cost services, many will be looking to utilize smaller, outpatient facilities. A few REITS in this asset class are: American Realty Capital Healthcare Trust, Inc. and HCP, Inc. (although there is often overlap between this category and the following).

SENIOR HOUSING

With millions of baby boomers set to reach retirement in the coming decade, researchers expect a dramatic spike in demand for all types of senior housing. This includes adult living communities, assisted living facilities and nursing homes. REITs holding these types of real estate assets include National Health Investors, Inc. and Senior Housing Property Trust.

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SINGLE-FAMILY REITs POISED TO SUCCEED

By Carla Freeman, Real Estate Partner, BDO USA L.L.P.

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 though 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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SEAL THE DEAL: CFOs PLAY CRUCIAL ROLE IN MINIMIZING POST-ACQUISITION DISPUTES IN THE REAL ESTATE INDUSTRY

By Jeffrey M. Katz, CPA/ABV, CFF, CFE

MERGER & ACQUISITION (M&A) ACTIVITY IN THE COMMERCIAL REAL ESTATE INDUSTRY HAS SEEN A SIGNIFICANT INCREASE IN 2013 AND 2014, WITH BOTH TRADITIONAL PARTIES AND PRIVATE EQUITY FIRMS ACTIVE IN THE TRANSACTIONS.

With an increase in commercial real estate M&A transactions, it is important for CFOs involved to understand the post-acquisition dispute issues that often arise after closing. CFOs who proactively consider common post-acquisition dispute issues before an agreement is reached can minimize the chances of being distracted with such disputes, and can instead focus on integrating the newly acquired business, driving operational efficiency and setting the company on a path for growth.

M&A agreements often contain a post-closing adjustment to the purchase price, which typically reflects differences in the balance sheet of an acquired company between the date a deal is negotiated and the date the transaction closes. While the metrics for adjustments vary from one agreement to the next, adjustments are often based on the change in a business's Net Working Capital, Net Assets and/or Company Debt. Disputes often arise because the parties to an M&A agreement have differing opinions regarding the amounts that should be recorded on the closing balance sheet. In the commercial real estate industry, these disputes often focus on the application of generally accepted accounting principles (GAAP) within the context of the terms of the M&A agreement.

For example, M&A agreements may contain language that requires the closing date balance sheet to be prepared in accordance with GAAP and consistent with a company's past policies, practices and procedures. Post-closing purchase price adjustment disputes often arise when a company's past practice is not in accordance with GAAP and the M&A agreement is silent on which should prevail—past practices or GAAP. In real estate industry M&A transactions, we often see this issue in regards to security deposits. Many companies simply record security deposits as a current liability on the balance sheet, even though many of the security deposits will not be returned for more than a year and could be more appropriately classified as a long-term liability under GAAP. If the post-closing purchase price adjustment is based on a Net Working Capital measurement, a dispute could occur. CFOs can play an important role in minimizing transaction disputes by suggesting clarifying language in the agreement that specifies which methodology takes precedent. If the parties' intent is that the closing date balance sheet be prepared in accordance with past policies, practices and procedures, then the parties should consider avoiding any reference to GAAP in the M&A agreement provision that discusses the preparation of the closing date balance sheet.

As CFOs are aware, GAAP requires management to make judgments and estimates in preparing financial statements. However, in an M&A transaction, buyer management and seller management might have differing estimates for the same balance sheet item, even though both estimates are in

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POST-ACQUISITION DISPUTES

accordance with the technical requirements of GAAP. Real estate companies, for instance, often enter into construction projects, which are accounted for in financial statements utilizing a cost to complete methodology. With this methodology, it is necessary for management to make judgments and estimates about the future costs to complete the construction project. In some transactions, the buyer's assessment of such costs to complete is significantly higher than the seller's assessment of the costs to complete. As a result, such items can be the focus of post-acquisition dispute claims. CFOs involved in an M&A transaction in the real estate industry may want to suggest the inclusion of language in the agreement that removes the subjective nature of such estimates.

In addition to Net Working Capital adjustment provisions, many M&A agreements contain earn-out provisions intended to bridge the buyer and the seller's differing views on the value of a business. Because these provisions frequently have a financial-related metric that the seller needs to achieve in order for the buyer to pay the additional purchase, it is important to be aware of changes in GAAP that could impact an earn-out calculation. For example, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) recently issued new revenue recognition guidance intended to provide information in financial statements about the nature, timing and uncertainty of revenues from contracts with customers. While most of the changes do not go into effect until 2017, CFOs should be aware of how these changes might impact M&A transactions.

While earn-out provisions may not be seen in every real estate M&A transaction, it serves as a good example to highlight how changes in GAAP can impact an M&A transaction. Because earn-out targets are often based on historical financial performance projected for future performance, the revenue recognition changes can result in establishing future financial targets according to current guidance, even though the actual future financial results will be calculated using the new revenue recognition standard. This inconsistency could result in post-closing issues because the seller may or may not earn contingent consideration solely due to a change in GAAP and not the underlying performance of the company. CFOs can add value to the deal team by making sure that changes in GAAP are taken into account when the parties are negotiating the terms of an M&A agreement.

The more CFOs take the time early on to consider common M&A post-acquisition dispute issues within the real estate industry, the more proactive they can be in providing guidance to deal teams negotiating the terms of an agreement. Furthermore, the understanding that M&A agreements are subject to interpretation and disagreement between the buyer and seller gives CFOs the advantage of minimizing post-acquisition disputes so they can avoid distraction and focus on a seamless integration with the newly acquired business.

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