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SUMMER 2014
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THE NEWSLETTER OF THE BDO REAL ESTATE INDUSTRY PRACTICE

REAL ESTATE MONITOR

TOP RISKS FOR REITs IN 2014

By Stuart Eisenberg

THE REIT LANDSCAPE IS CONSTANTLY SHIFTING, WITH NEW AND EVOLVING RISKS IMPACTING THE INDUSTRY.

The *BDO RiskFactor Report for REITs* is a yearly study that analyzes the risk factors cited by the 100 largest publicly traded REITs in the U.S. in their most recent 10-K filings. The study, which is now in its third year, examines the most commonly noted risks and ranks them by order of frequency cited.

In this year's study, 94 percent of REITs say competition for lessees and prime real estate is a top risk, ranking it the third most frequently cited risk for a second consecutive year. With healthier market activity, more businesses may have a need to expand into new or larger office spaces, creating a greater pool of potential lessees over which REITs' property owners may compete. The multi-family sector, on the other hand, may see more prospective tenants looking to rent if people remain cautious about job security, stray from home ownership or prefer to live in more urban environments.

Across the board, this intense focus on competition may be driving REITs to make capital improvements to retain and attract tenants, as well as explain why 82 percent of REITs cite operational expenses and renovation costs as a key concern this year, up from 77 percent last year.

Many REITs are also paying close attention to the financial condition of their tenants, a steadily growing risk. This year, 79 percent of REITs cite this as a risk, up from 75

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TOP RISKS FOR REITs

percent last year and 71 percent in 2012's study. This is likely linked to difficulty of attracting financially stable tenants. Going hand-in-hand with this concern is the threat of property foreclosure and bankruptcy, which 73 percent of REITs say is a risk, up from 65 percent last year.

Finally, while the general consensus is that the real estate industry has made a solid post-recession recovery, 74 percent of REITs still cite declines or stagnation in business and real estate values as a serious concern, up from 64 percent in 2012. As REITs continue to adjust to the new landscape, it is evident that some trepidation remains.

BDO's report finds that amidst an improving real estate market, the REIT industry continues to face many risks. Consolidation within the industry and the difficulty of securing attractive lessees and tenants are propelling many of this year's top concerns. You can access the full report here: http://www.bdo.com/download/3270.

Read BDO's column every other month in CPE's Capital Markets newsletter, available by free subscription on CPExecutive.com.

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HOTELS: MOVING INTO BUILDINGS

By Alvin Arnold

WITH THE HOTEL INDUSTRY RECOVERING FROM THE LAST RECESSION, MANY CHAIN HOTELS ARE BEING REPURPOSED FROM EXISTING BUILDINGS SUCH AS OFFICES, WAREHOUSES AND HOSPITALS.

Behind the trend is the changing tastes of travelers who flock to cities seeking more modern and exciting accommodations.

The adaptive-use hotel is appearing in cities, such as Washington, New York, Boston and New Orleans. Executives at Marriott estimate that 10 to 20 percent of their Courtyards opening this year will be in repurposed buildings. For guests, forgoing the standard hotel template can mean such features as odd-shaped hallways, and better amenities like a well-known restaurant that draws patrons from the surrounding neighborhood.

Experts say it can often be quicker and less expensive to repurpose an existing building than to build a new one. Some hotel chains turn to the Federal Historic Preservation Tax Incentive Program of the National Park Service, administered by the IRS. It grants tax credits of up to 20 percent to help finance the rehabilitation of historic buildings to preserve their character. The federal program that is available in 50 states can also be "piggybacked" on to state historic tax credits available in over half the states.

In Europe, the InterContinental Hotel Group has embraced repurposed buildings for economic reasons. Banks are much more likely to provide financing for buildings that already exist.

The General Services Administration has reached an agreement to lease the Old Post Office building, at 12th Street and Pennsylvania Avenue in Washington, to the Trump Organization for 60 years with the option to renew. The chain estimates it will spend $200 million converting the building to a luxury mixed-use development, including a hotel, museum, visitor center and retail space.

Reference: *The New York Times*

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IN-STORE LEASING BY DEPARTMENT STORES

By John Tax, Assurance Director

According to Ira Fierstein and Scott Schonfeld of Seyfarth Shaw LLP, a current trend in retail leasing is the establishment of multiple, in-store "mini-malls" within the space occupied by anchor tenant retailers. Retailers, namely those that specialize in clothing and household goods (i.e., Macy's, JCPenney, etc.), will allow specialty retailers to "sub-lease" a portion of their floor space to establish a mini-mall to showcase their products. These anchor tenants see this arrangement as a way to:

- Offer new and varied products to their current customers
- Attract new consumers who traditionally would not patronize their stores
- Generate a new source of revenue from a decreasing need for space
- Reduce leasing costs in an uncertain economy

The store-within-a-store approach has been adopted industry-wide and analysts see the trend accelerating in the future, as the need for space decreases and the need for varied products increases.

Retailers, landlords and the prospective subtenants need to be mindful of the legal ramifications that this practice poses and, therefore, must structure the leases/agreements to avoid problems that may arise related to co-tenancy and anti-competition clauses included in leases.

▶CO-TENANCY CLAUSES

One issue of concern to landlords is the potential of violating co-tenancy provisions with other shopping center tenants. When an anchor tenant attempts to sign more than one sublease tenant, a mini-store can be created. Leases for other in-line tenants within a shopping center are often dependent on the continued presence and/or operation of an anchor tenant. A typical lease might provide that a tenant will not be obligated to keep open or keep operating its store at full rent unless one or more anchor tenants are also operating. If the anchor tenant violates its lease and/or ceases to exist, this could cause issues with other in-line tenants.

The landlord needs to restrict an anchor tenant's ability to assign or sublet. Since most anchor tenants will insist on some flexibility with regard to such arrangements, one possible compromise would be to allow the anchor to assign to another national single-occupant retailer or to sublease to not more than two other operators and that the store should continue to have the appearance of a single operator.

A landlord must also take care in drafting the co-tenancy language in the leases of the other tenants in a center so that the landlord is not adversely impacted if another tenant vacates. It makes sense to draft the lease in such a way as to not specifically identify a particular anchor tenant as a requirement for another tenant's continued lease obligations; rather anchor tenants should only be described with generality. From the tenant's perspective, a replacement tenant(s) should be permitted in the event that an anchor ceases to operate.

▶ANTI-COMPETITION CLAUSES

Another area of concern to landlords related to this practice is the potential of violating anti-competition clauses that may be included in in-line tenant's leases. When an anchor tenant enters into leasing arrangements with subtenants they should consult with the landlord in order to confirm that the subtenants to whom they are looking to lease space are not involved in selling products or providing services that would cause problems with in-line tenants. It is not anticipated that this would be a prevalent problem, but it is one that should be considered as the mini-mall concept continues.

These arrangements are becoming increasingly common and, thus, should be considered a significant development in commercial real estate. However, because these arrangements pose concerns, care must be exercised in the drafting of leases, not only with anchor tenants but also with the other tenants in the shopping center. Companies drafting leases which contain co-tenancy or anti-competition provisions should contact a legal professional to review and revise their leases in order to avoid or mitigate such concerns.

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REVERSE MORTGAGES – BORROWER'S DEATH

By Robert Klein

WHEN THE BORROWER DIES, CAN THE LENDER FORECLOSE ON A SURVIVING SPOUSE NOT NAMED IN A REVERSE MORTGAGE LOAN? A RECENT CLASS-ACTION LAWSUIT COULD HELP CLARIFY THE ISSUE.

Four surviving spouses asked the court to halt foreclosures on their homes in a lawsuit against the Department of Housing and Urban Development (HUD). The lawsuit highlights the need for clarification of contradictory language about the rights of non-borrowing spouses in its rules for the Home Equity Conversion Mortgage program.

Last year, a federal court ruling found a conflict between HUD's regulations, and federal laws that are designed to help surviving spouses. The court ruling directed the agency to resolve the issue. HUD appealed the ruling, but has since withdrawn the appeal.

Reverse mortgages allow homeowners 62 years or older, to borrow money against the equity on their homes. The mortgages are not required to be paid back until the borrower moves out, or dies. These mortgages allow older homeowners to remain in their houses, and get cash for their retirement.

HUD is the de facto regulator for reverse mortgages. Home Equity Conversion Mortgages (HECMs) have long dominated this market, and account for roughly 99 percent of recent originations.

Regulations for reverse mortgages by HUD require banks to offer survivors the ability to settle the loan for 95 percent of the home's current value. In addition, lenders must offer the heirs up to 30 days to decide what they want to do with the property, and up to six months to arrange financing.

The alleged rule conflict stems from the 1988 statute that established the HECM program and subsequent regulations, according to the plaintiffs. Subsection of the statute under the title "Safeguard to Prevent Displacement of Homeowner" states that a HECM cannot be called due and payable until the death of the homeowner, and specifies that for purposes of the subsection, the term "homeowner" includes the spouse of the "homeowner."

However, HUD regulations "substitute the term 'mortgagor' for 'homeowner' and 'spouse' and state that the duty to satisfy the mortgage occurs when the 'mortgagor dies and the property is not the principal residence of at least one surviving mortgagor,'" according to the lawsuit. HUD also defines mortgagor as "each original borrower under a mortgage" and specifies that "the term does not include successors or assignees of a borrower."

Three of the four plaintiffs in the above case quitclaimed, or signed away their rights to, the properties, but allege in their court filing that they did so without realizing it, "or under the fraudulent promise" that they would be protected.

Reverse mortgage lenders believe they adhere to federal rules and note that their objective is to avoid costs and time-consuming foreclosures. In addition, government officials and lenders try to be sensitive to the rights of senior citizens. But the program's financial concerns have created pressure to contain losses. As a result, the FHA has been engaged in ongoing reform efforts to balance the two concerns in such a way that the program can continue to operate.

The National Reverse Mortgage Lenders Association has refrained from public comment on how to interpret non-borrowing spouse rules, citing involvement with the related litigation through a friend-of-the-court brief it filed last year in support of a need for HUD clarification.

But making sure senior borrowers and their heirs understand the somewhat complicated product has proved tricky and time-intensive. The interpretation of the non-borrowing spouse rule by different partners is just one example.

There is pressure for reform of non-borrowing spouse rules and some possible solutions have been proposed. Among other things, it is suggested making quitclaimed loan applications ineligible for FHA insurance, or subject to extra underwriting, to ensure the non-borrowing spouse is protected from displacement.

A resolution of the recent case could result in clearer rules for the long term for lenders that originate and service reverse mortgages.

Reference: *National Mortgage News, Consumerist, The New York Times*

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PErspective in Real Estate

While the U.S. real estate market encounters slow, steady growth -- with many distressed opportunities already picked over -- the U.S. lodging sector is delivering opportunity that is keeping private equity investors and lenders bullish. According to JLL's Hotel & Hospitality, a global hotel and hospitality real estate advisor, the hotel sector is on track to reach $25 billion in transaction volumes in the U.S. in 2014.

A number of factors are driving this resort revival, including an abundance of capital led by private equity, REITs and offshore buyers, strong debt markets and rising revenue per available room (revPAR).

While hotel real estate is trading at a premium price in cities like San Francisco and New York, private equity firms are thinking outside the box to get better returns. Lodging that exists in smaller markets or hotels that offer fewer services have lower operating costs than more upscale properties, with higher returns, according to Bloomberg. Secondary markets like Denver, Nashville and Phoenix have experienced strong revPAR growth, posting double-digit increases as of June 2014, according to JLL's Hotel & Hospitality.

Blackstone has been a significant player in this space. In 2012, Blackstone bought the Motel 6 and Studio 6 Budget chains; in September 2013, Blackstone acquired 16 hotels from Hersha Hospitality Trust; and most recently, is close to an agreement to purchase a group of select-service hotels from Clarion Partners LLC – which would include 47 extended-stay Residence Inn and Homewood Suites hotels, according to Bloomberg. American Realty Capital Hospitality Trust Inc. (ARC Hospitality) also recently agreed to acquire the Equity Inns lodging portfolio for $1.925 billion from Whitehall Real Estate Funds, real estate private equity funds sponsored by Goldman Sachs. The purchase will create one of the largest hospitality REITs in North America, consisting of 125 hotels in 35 states.

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

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