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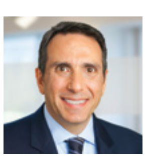
THE NEWSLETTER OF THE BDO REAL ESTATE AND CONSTRUCTION PRACTICE

REAL ESTATE MONITOR

ROUNDTABLE: WHAT'S TO COME IN 2016 FOR REAL ESTATE AND CONSTRUCTION?

As we approach the new year, we sat down for a broad discussion with our real estate and construction leaders to discuss the many trends and issues in the industry that captured our attention this year, and reveal expectations for the year ahead.

2015 was a landmark year for foreign investment in commercial real estate, particularly in gateway markets. At the same time, we saw an increase in domestic interest in smaller secondary markets. Do you foresee foreign investors turning an eye toward these emerging areas over the next year or continuing to stick with safer markets?



Stuart Eisenberg: Thirty-one percent of all foreign investment went into New York City last year, and we saw investment flowing into other major markets like Los Angeles and San Francisco. While we have seen some traction moving away from these markets, foreign investors are primarily looking for safety, which they're able to find in gateway cities. We do expect to see growth in secondary markets continue into 2016, but it'll likely be among domestic investors, such as private equity groups looking for growth opportunities and higher returns.

What property types will investors be attracted to in 2016? Which real estate and construction sectors do you foresee having an eventful year?

SE: Residential had a strong year of growth, and we could see that begin to soften in 2016 as it reaches a point where rents might not have much more room to increase. Hospitality and hotels are also having an interesting moment. A lot has been said about Airbnb, but its impact is really

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BDO REAL ESTATE AND CONSTRUCTION PRACTICE

BDO's Real Estate and Construction 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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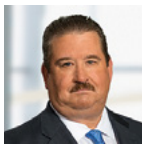
concentrated in certain markets, like New York and San Francisco, where there are a lot of units. Elsewhere in the country, though, hotels are doing fairly well and are very attractive from an investment perspective as well as a cash-flow standpoint.



Tom Menk: I echo Stuart's take on the hotel sector. In Pittsburgh alone, we've had a number of new hotels open this year.

Overall, 2015 has been a good year for construction, with some of the strongest markets being offices, multi-family dwellings and single-family homes. The office construction market grew by about 15 percent this year, and that's expected to carry over into 2016, though possibly at a slightly slower rate. Residential construction has been healthy as well, especially for multi-family properties. That trend is expected to decrease slightly, but single-family home construction is likely to increase in 2016 and beyond. I think that's driven a lot by millennials, who had been hesitant to settle as they weathered the economic downturn. Now that the economy is showing positive signs and as millennials start families, many renters might look to move to the suburbs and buy a home.

SE: I think investors and developers alike are wondering what the suburbs will look like in the next 10 to 15 years, which is definitely impacting the residential, retail and office sectors. The driving trend has been toward making the suburbs more urban in nature with a higher density and more amenities close by, and this gives people more ability to walk rather than drive, which is distinctly urban.

You mentioned the strength of the office sector. What are some of the factors driving that sector's resurgence?

SE: The sector has seen an uptick in occupancy rates and increased demand for space. The suburban office market is still relatively soft, but even that sector is gaining some traction. The focus has been on CBDs, as we've seen a greater desire to locate in cities, particularly among technology companies. They like being in urban areas where they have greater access to talent. The trend is toward more people working in offices with much less space. People aren't working from home—they're working in collaborative groups and closer quarters.

Relatively low levels of inventory and high demand characterized the industry during 2015. How has that impacted construction and how might it shape the outlook for 2016?

TM: For the construction industry, we're expecting the overall outlook to be fairly consistent with what we saw in 2015—strong across sectors. Demand is up, though that hasn't had a big effect on the price a contractor gets for their services. Over the past few years, owners have grown accustomed to a softer market and being able to negotiate hard with contractors to get the best price. For that reason, margins haven't improved significantly even with the increase in demand.

A new lease-accounting overhaul rule could effectively boost the debt that companies must report on their balance sheets by tens of billions of dollars. While this guideline was just voted on, it won't be in effect until 2018. How might this impact…

Lessees?

SE: This is still a controversial issue. For many businesses, retailers in particular, the largest asset and liability on their books could become their lease obligations. The challenge will be in explaining that to investors and lenders, so some metrics will have to change. Currently, retailers and other operating businesses have elected to lease rather than buy locations, or even sell and lease back existing locations, to reduce balance sheet assets and liabilities to appease the investment community. This new rule may cause a major shift in management plans, as the balance sheets would reflect large "non-income producing" assets and associated debt or lease liabilities, whether a business chooses to lease or own the space in which it operates.

Because the implementation isn't due until 2018, in the short term, I'd expect to see a push for education for the users of financial statements and for retailers and landlords to develop a strategy to address it.

Landlords?

SE: Beyond the accounting implications, I wonder how this will affect the broad dynamics of landlords buying properties and leasing them out in large blocks to tenants. It could shift the dynamic back toward real estate ownership by corporations as opposed to leasing from landlords. Or tenants might choose to sign shorter leases, 3- or 5-year leases, to minimize the liability on their books, which could cause challenges for landlords seeking long-term financing for properties.

Contractors?

TM: From a construction perspective, the property is going to be built either way, whether owned by a corporation or a landlord. From the perspective of our contractor clients, their equipment which

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may have been treated as operating leases under the old rules will need to be reflected as an asset and debt on their balance sheets. The impact of these changes will need to be discussed with their sureties and banks.

REITs and other owners of real estate?

SE: Most of the biggest retailers, like Walmart and Costco, are public, and they may consider buying properties over leasing them if they have to classify the lease as a liability. This might hurt REITs and other owners of rental real estate as there could potentially be fewer properties available, which could impact future growth.

The fate of the near-zero interest rates the industry has enjoyed since late 2008 hangs in the balance. If rates increase, how would the hike impact…

Investors?

SE: Investment activity has ramped up while interest rates have been so low. Lots of investors entered the real estate market or bought REIT shares because of the yield. If interest rates go up, that could cause a reduction in distributable cash flow and dividends for REIT investors. Money could get re-deployed elsewhere if investors jump ship and choose alternative investments for a safer yield. The market may already have factored this in. REITs have been impacted by the expectation of rate increases, and are trading at a nearly 12 percent discount to their net asset value, *The Wall Street Journal* recently reported.

Developers?

SE: From the developers' perspective, they have to price deals accordingly if interest rates go up. Developers in the midst of building projects will have to factor in higher costs to their deals, and keep in mind that the exit sale price of a property may not be as high as it is right now.

REITs?

SE: Higher interest rates impact REITs' ability to raise capital and also might cost them more to operate. Costs will go up as they work to finance new deals, so we could see REITs accelerating deals now to lock in the favorable rates.

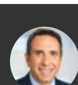
Contractors?

TM: The relatively low cost of money right now helps contractors, as well. If interest rates start to move up, developers that may have been on the fence could be looking to jump-start projects to take advantage of the low cost of money, as long as the other economics of the deal make sense.

What outside influences do you predict will most heavily impact real estate and construction in 2016?

TM: The construction industry is facing a talent deficit, and there's a big need right now for companies to bring in younger talent to replace baby boomers that have retired or will retire over the next few years. Not only has the construction industry struggled to sell itself to younger workers, but during the downturn, many companies decided not to bring young people in, and now many of them are struggling to replace that workforce. Beyond that, though, I'd say the general uptick in the U.S. economy, and the confidence it's giving people, has really bolstered construction.

SE: I'd echo that optimism on the economy overall, but also add that in commercial real estate, there's a backlog with lots of projects in the pipeline right now. Demand is always a consideration in the real estate cycle, particularly in the residential sector. Right now, once a project gets funded, developers are wondering if demand will hold strong while they're building the property. In certain markets, a significant amount of units will be added to the multi-family stock, and the question is whether demand is going to stay strong, especially if the expected shift toward buying a home as opposed to renting materializes.



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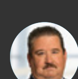

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DID YOU KNOW…

Closed-end and private real estate funds raised $37.5 billion in Q3 2015, the largest amount ever raised in a single quarter, according to Preqin's Quarterly Real Estate Update.

Construction employment grew by 31,000 in October, to 6.43 million, and by 233,000 over 12 months, according to Bureau of Labor Statistics data.

Urban Land Institute's Real Estate Consensus Forecast projects hotel revenue per available room to grow 7.9 percent in 2015, 5.9 percent in 2016 and 4.2 percent in 2017.

The apartment and condominium market experienced its 15th consecutive quarter of growth conditions in Q3 2015, according to the National Association of Home Builders' Multifamily Production Index.

Real Estate CEOs/CFOs are the highest paid in the business world, according to the BDO 600 CEO and CFO Pay Study, with average compensation at $4,515,764 and $1,818,693, respectively.

According to *Commercial Property Executive's* CPE 100 Quarterly Sentiment Survey, 78 percent of executives surveyed named secondary markets as the category that will attract the biggest increase in investor interest during the next 12-18 months.

The office sector has enjoyed a solid increase in demand in 2015, with net absorption up 30 percent year-to-date from last year, according to NAREIT's Q3 2015 Commercial Property Update.

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NAUGHTY or NICE:

Business executives,

Which states and locations will bring you holiday cheer all year long?

By Tom Stringer & Michelle Cammarata

The new year is right around the corner, and corporate C-suites are abuzz as executives decide how to deploy capital during the 2016-17 cycle.

With competition for investment growing fiercer than ever, executives and their consultants have the dual luxuries of mobility and choice. So if you're contemplating a relocation or expansion or are consolidating operations, you will inevitably be evaluating your existing locations to determine if they are productive business partners.

How do you decide which economic development agencies are naughty or nice? We've made a list and checked it twice—find out which development practices are helpful and which are worthy of a lump of coal.

NICE LIST

Locations meeting these rules just might find a few shiny new companies under the tree this year:

FEEL THE LOVE:

Though it might have been repeated more often than the chorus of "Jingle Bell Rock," this rule is time-tested and critical: the best economic development agencies treat their existing business community as a valued partner. They don't disappear after the ribbon cutting ceremony. Smart economic developers stick around, answer questions and are willing to help businesses succeed. A business that feels valued and understood rewards its community with growth, new leads, strong references and a warm holiday glow that lasts all year long.

PLAY WITH THE ALL-STAR TEAM:

Stronger teams are simply better suited for winning projects and being active partners after the deal is won. Get and stay organized, know your product through and through, and work overtime to provide information and answers to key stakeholders quickly. You'll be on the nice list and your community will land on the short list among companies looking for a new home.

BORING IS THE NEW GLAMOROUS:

Businesses thrive on certainty. In this context, boring isn't a drag; keeping things predictable is good for planning purposes. Smart businesses want to look years ahead and be reasonably certain of tax rates, assessment methods, incentive programs and other key financial and operational considerations. So go ahead, look for a community that is the right kind of boring!

FIND SANTA'S HELPERS:

In government matters, red tape is the equivalent of fruitcake on the holiday dessert table. Red tape may be unavoidable, but with the right strategy, it can be managed and minimized when helping companies apply for incentives and permits. Find an economic development partner who knows the system and acts with a sense of urgency.

KNOW WHO NEEDS YOU:

Like Hermey the Misfit Elf turned dentist, the best agencies play to their strengths. Rather than trying to be all things to all companies or all industries, they target the best fit for their community's demographics, labor force and business environment. It's worth investing in location analysis to cut through the blizzard of sales and marketing to find your match.

NAUGHTY LIST

Locations that treat companies like this could wake up with coal in their stockings:

RUN FROM A SCROOGE:

In recent years, several states and cities have broken their commitments for incentives, even while the businesses were meeting their commitments. Locations with a history of reneging on their incentives deals risk being seen as the misfit toys of the site selection industry. Trust is hard to regain, but bad memories linger.

WATCH OUT FOR SMOKE AND MIRRORS:

Don't expect to feel the holiday magic if your state stuffs its incentives packages full of complex tax credits, training services and

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NAUGHTY OR NICE

other benefits your company may never use or need. Companies want tangible benefits they can use, and the most desirable incentives packages maximize cash or cash-equivalent savings in the early years when expenses are high.

VALUE EFFICIENCY:

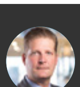
Some economic development programs operate more like the DMV rather than Santa's lean factory line, with complex applications, long multi-layered review and approval processes and staff who fail to communicate. These inefficiencies will blow your deadlines, costing time and money. Look for a stronger partner in your region or hop the next sleigh out of town.

DON'T WAIT TO BE CALLED ON:

In today's economy, each and every asset can be monetized, and businesses are more mobile and more aware of their worth than ever. If you're committed to your community but want to explore savings opportunities, you might need to make the first move. Not every agency excels at business retention and, in fact, most prefer to chase new businesses like kids looking for shiny new toys.

BEWARE OF TAXATION WITHOUT COMMUNICATION:

When evaluating locations, companies might be wondering about the return on the investment of a particular location. How are the roads, schools and other assets? States and jurisdictions need to understand their value proposition and actively communicate it. If you can't show companies value for their taxes paid, get to work on those metrics.



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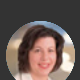

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PErspective in REAL ESTATE

Deal activity in the commercial real estate sector is growing amid soaring property values and an increased appetite for risk, according to the *Wall Street Journal*.

While many post-crisis investments have focused on core properties—fully leased buildings—some investors are now looking for funds that buy into new developments and other riskier assets, often looking for 20 percent yield or more. Morgan Stanley, hit especially hard by the last housing crisis, recently raised a $1.7 billion higher risk fund, marking a recovery from the downturn, the *Journal* reports.

Among residential real estate acquisitions, private equity is increasingly replacing developers in deals for large buildings and apartment complexes, especially in New York, according to *Fortune*. Blackstone Group—the world's largest private equity real estate investor—recently made a major push into multifamily apartment holdings with its $5.3 billion acquisition of Manhattan's largest apartment complex, Stuyvesant Town-Peter Cooper Village. Blackstone's CEO Steve Schwarzman predicts "core" properties such as this may eventually make up $100 billion in assets for the firm, according to *Bloomberg*. Turning to apartments later than some of its peers, Blackstone has acquired 46,000 units over the last two years, *Bloomberg* reports.

Blackstone's largest real estate deal in 2015 was its $23 billion acquisition of a portfolio of properties from General Electric. In addition to significant new investments, the PE firm has also returned $25 billion to investors from property sales since September last year, more than half of its total realizations of $45 billion for the same period, according to *Bloomberg*.

The hospitality sector is in the middle of a consolidation boom, as hotel brands look to boost their profits, add hotel rooms and grow their geographical footprint before the peak of the growth cycle, according to the *Financial Times*. Marriott International has announced it will buy Starwood Hotels in a deal valued at $12.2 billion, creating the world's largest hotel company, and French hotel group Accor looks set to buy FRHI Hotels and Resorts for $3 billion. While some hotel chains have sufficient cash for new acquisitions, they face stiff and growing competition from Chinese investors, who are expected to buy some $5 billion worth of hotel assets this year, the *Financial Times* reports.

This M&A boom also presents exit opportunities for PE firms. For example, Goldman Sachs, Avenue Capital and GoldenTree Asset Management are considering a sale of U.K. budget hotel group Travelodge, Carlyle Group is looking to sell its 80 percent stake in French budget chain B&B Hotel Group, and Lone Star has put its Atlas Hotels portfolio up for sale.

There are opportunities for private equity firms in every corner of the real estate market. However, real estate funds should expect increased regulatory scrutiny in the coming year. Blackstone and KKR both paid multimillion-dollar settlements in 2015 over allegations that they did not properly disclose to investors special fee arrangements, discounts and waived "broken-deal" expenses that benefited certain investors, including company executives. In 2016, real estate funds can expect heightened SEC oversight of their business relationships, particularly over the potential hiring of businesses they control to do work for their portfolio companies, according to SEC Chair Mary Jo White.

PErspective in Real Estate is a feature examining private equity investment in the real estate sector.

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TOP 2016 RESOLUTIONS FOR REITs

By Anthony La Malfa

For many, New Year's resolutions serve as an annual clean slate, offering an opportunity to overhaul habits and focus on getting healthy once and for all.

The all-too-familiar problem, though, is that oftentimes, these resolutions are abandoned before the winter snow melts. This year, there are a few resolutions REITs can make—and, more importantly, keep—to start off the new year on the right foot, get their balance sheets healthy and power through 2016:

REDUCE RELIANCE ON LOW-RATE DEBT.

Many analysts predict that near-zero interest rates could soon be a thing of the past. With a strong chance that the Federal Reserve will raise short-term interest rates by the end of this year, REITs should take advantage of low rates and consider accelerated refinancing in order to lock in favorable rates before the current cycle of low interest rates ends. As higher yield investments, REITs can experience more sensitivity to interest rate changes than some other investment classes. REITs should address their reliance on low-rate debt when building 2016 expansion plans, as higher interest rates will mean increased costs on financing for new properties and refinancing of existing debt.

DIVERSIFY PORTFOLIOS TO REDUCE RISK.

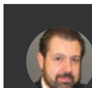
As REITs answer market demands for clearly communicated and focused strategy, some are choosing to diversify to minimize risk and encourage greater risk-adjusted returns over time. And more REITs are diversifying: according to REIT.com, the number of diversified REITs has nearly doubled since 1999. However, even companies that have a diversified mix of assets are smart to choose a regional portfolio focus to maintain a unique value proposition and control exposure to concentrations in markets with less upside potential. A smart diversification strategy, whether by property type or location, is considered essential in maximizing shareholder returns over the long term.

MONETIZE ASSETS IN MORE MATURE MARKETS.

To stay ahead of the herd, REITs might consider monetizing their assets in gateway markets, many of which are slowing, in pursuit of a portfolio focused on emerging markets with high growth potential, like Austin, Texas, and Savannah, Ga. Strategically selling some assets in larger, more established markets like New York or Chicago will free up capital, allowing REITs to pursue deals in secondary markets that might be at an earlier point in the growth cycle and ultimately might provide a better return.

ENHANCE TRANSPARENCY AND DUE DILIGENCE.

Smart REITs will work to strengthen communications with key stakeholders around performance and business risks to ensure nothing is overlooked in the development and implementation of the new year's business strategy. The 2015 BDO RiskFactor Report for REITs reveals insights about the ever-evolving REIT landscape, in which REITs are not only subject to risks around industry-specific concerns related to taxes and compliance but also the fluctuations of broader market fundamentals. High standards of due diligence and increased transparency around risks and outcomes will help REITs continue to thrive in 2016 and beyond.



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COMPENSATION TRENDS FOR REAL ESTATE CEOs AND CFOs

By Anthony La Malfa

Real estate industry CEOs and CFOs were the highest paid across eight major industry sectors during 2014, according to *The BDO 600 CEO and CFO Pay Study.* Last year, real estate CEOs and CFOs were the second most compensated, falling right behind executive leaders from the energy sector.

The analysis was conducted by BDO's dedicated Executive & HR Practice, and examined proxy statements of public real estate companies with annual revenues between $25 million to $1 billion.

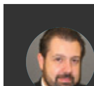
This number one ranking could be attributed to the positive economic climate during 2014 and an increase in overall business. It could also be due to real estate CEOs' and CFOs' growing role and the increased complexity of the real estate industry, which now necessitates not only an understanding of their industry, but how advancements in other sectors, like technology, are significantly impacting their business. Another factor possibly contributing to the ranking is the sophistication required to navigate the changing debt and equity markets, which saw significant swings for real estate companies.

While the real estate sector comprises the highest compensated executives, real estate CEOs did experience a 1 percent decline to $4,515,764, from $4,553,611. Average real estate CFO compensation, however, increased to $1,818,693, an 8 percent year-over-year increase. This disparity between real estate CEO and CFO pay was in alignment with the study's overall finding that in 2014 CFO year-over-year compensation outpaced that of the CEO.

According to Randy Ramirez, a senior director in the Global Employer Practice at BDO, "There is clearly a sense of cautious optimism when it comes to the economy given its skittish performance and high volatility. Because of this, CEO and CFO compensation is rising at a more measured pace when compared to last year."

Ramirez continued, "Companies also want to capitalize on bullish market days and, as a result, are incentivizing their executives to accelerate bottom-line growth and unlock greater shareholder value. CFO compensation, in particular, is benefiting as it outpaced CEO pay growth. One possible explanation is the increased responsibility placed on CFOs to leverage market momentum in order to realize a company's financial vision."

This article also appeared in Commercial Property Executive.



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MARK YOUR CALENDARS

The following is a list of upcoming conferences and seminars of interest for Real Estate and Construction executives:

JANUARY

Jan. 19-21
NHMC Annual Meeting
Hilton Orlando Bonnet Creek/
Waldorf Astoria
Orlando

Jan. 25-27
America's Lodging Investment Summit*
JW Marriott & Microsoft Theater
Los Angeles

FEBRUARY

Feb. 23-24
NAREIT Washington Leadership Forum
St. Regis
Washington, D.C.

Feb. 24-27
American Institute of Constructors Annual Forum
Sheraton Hotel & Marina
San Diego

Feb. 25
Real Estate Women's Forum
The New Yorker Hotel
New York

MARCH

March 7
PREA CEO Leadership Forum
The Westin Copley Place Boston
Boston

March 8-9
PREA 2016 Spring Conference*
The Westin Copley Place Boston
Boston

March 30-April 1
NAREIT REITWise Law, Accounting & Finance Conference*
Washington Marriott Marquis
Washington, D.C.

** indicates BDO is hosting or attending this event*

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