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THE NEWSLETTER OF THE BDO REAL ESTATE INDUSTRY PRACTICE

REAL ESTATE MONITOR

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BDO REAL ESTATE AND HOSPITALITY SERVICES PRACTICE

BDO's Real Estate and Hospitality Services 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.

REAL ESTATE: 10 TOP ISSUES

By Alvin Arnold

As the condition of the global economy continues to cause uncertainty across all industries, The Counselors of Real Estate, an international professional association of top real estate executives, asked its members to identify the top 10 broad structural issues that will define the real estate industry over the next 10-30 years. They are briefly described below.

1. AGING

The aging of the population will broadly and dramatically affect real estate markets from housing, retail sales, health care and myriad factors that define the success of different geographic areas. Aging will most directly affect the demand for real estate, but will have scores of less direct effects, such as potential capital impacts as the pensioners by the scores of millions move from being net contributors to net users of capital.

2. FUNDING OF PUBLIC EMPLOYEE RETIREMENT SYSTEMS

Underfunding of state and local retirement systems in the trillions of dollars provides extreme challenges to the provision of basic local and state services critical to real estate properties and markets. Can existing government assets be tapped for cash in a way that makes economic sense and does not shortchange future generations?

3. STUDENT DEBT BURDENS

Student college debt averages around $45,000 per student with a total that exceeds consumer debt for the first time. How will such burdens change the patterns of spending, household formation and financial growth of this generation of graduates?

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10 TOP ISSUES

4. INFRASTRUCTURE FUNDING AND U.S. COMPETITIVENESS

Creative public-private partnerships with state and local governments are being viewed as potential supplements or replacements for federal funding of the next generation of needed infrastructure improvements, and could cover the trillions of dollars of deferred maintenance of existing assets.

5. CHANGING OFFICE AND RETAIL DEMAND

Radical reductions in office space usage by larger occupants due to increased use of technology, acceptance of alternative work systems and changes in retail as Internet purchases change the role and purpose of physical retail space will define winners and losers going forward. Additionally, the Panama Canal expansion and East Coast port expansion are changing the dynamics of warehousing.

6. REAL ESTATE CAPITAL MARKETS LIQUIDITY

Capital limitations on banks as a result of Dodd-Frank and other new rules applicable to real estate raise concerns about the scale of returns of the commercial mortgage-backed securities (CMBS) market. Hundreds of billions of dollars of real estate loans that must be refinanced in the next several years and growing capital demands by other sectors of the economy will create continuing uncertainty over access to capital. Smaller properties, properties in secondary or tertiary markets and properties with weak borrowers, substantial vacancies, high tenant rollover in early years or other risk factors are already experiencing a severe capital shortage.

7. GLOBAL CHANGE AND UNCERTAINTY

The political gridlock and budget crisis in the U.S., the European financial crisis, the pending (now underway) slowdown of China's economy, uncertainty and slow growth in the Middle East and continuing expansion of global interconnections make uncertainty about the future of finance a certainty. What does it mean for real estate investment in the U.S. and abroad?

8. INTEGRATION OF SUSTAINABILITY

Sustainability has moved beyond gimmick status and toward becoming part of corporate governance, management and reporting systems, and supply chains of many companies – increasing the value of sustainable property investment. How must real estate businesses adapt to keep up?

9. LOW CAP RATES

Cap rates for core properties are back to troubling 2007 levels. What happens if interest rates increase and cap rates decompress? Has the industry set itself up for another disastrous value decline?

10. CIVIL DISCORD AND POLITICAL GRIDLOCK

Many of the key issues and challenges require broad consensus to solve. Will there be greater cooperation, or will political gridlock continue? Answers to this question will be critical to determining the future of the real estate industry and societies of the world.

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12 WAYS TO USE REAL ESTATE EASEMENTS

By Brian Bader

One reason why real estate is a popular investment is that a variety of legal interests can be created, thus permitting great flexibility in forms of ownership and extent of use. This most often is in connection with equity and debt financing. However, the flexibility of legal interests also is important to users of real estate. The most common example is the creation of a lease instead of a fee interest.

However, a lesser-known type of interest is the easement. An easement is an interest in real estate that gives the holder of the easement a right to use or occupy the property in a particular limited way.

Easements on or adjacent to property often can increase the usefulness and value of a property at a very small cost. The cost can be either a one-time payment or a periodic fee. Alternatively, an owner can subject the property to an easement for the benefit of another as a means of increasing cash flow. Sometimes, easements can be exchanged (cross-easements) so that no out-of-pocket outlay is necessary. The following paragraphs describe various types of easements that are used in connection with different types of real estate.

1. RIGHTS OF WAY

One of the most common easements is the right to cross over the land of another. A right of way may be limited to a walking path or may extend to automobile traffic or the right to lay tracks for a rail-way spur (often necessary for industrial property). The holder of the easement, in addition to paying for the benefit, may be required to maintain the right of way. Use may be restricted to certain days or hours or may be unrestricted.

2. UTILITY EASEMENTS

Also very common are utility easements, which permit telephone and electricity poles and lines, as well as natural gas pipelines, to be built on or under the land. Such an easement normally includes the right to enter the land to repair or operate the utility lines as well as the right to clear the right of way of all natural growth that may interfere with the utility service.

3. LIGHT AND AIR EASEMENTS

This easement protects the right of an occupant of real estate to have access to light and air unencumbered by adjoining structures. The general rule in the United States is that there is no implied easement of light and air, so that absent an agreement, an adjoining owner may construct an improvement to any height and to the property line, assuming this is not barred by local zoning or setback requirements. Consequently, a light and air easement must be created by express agreement.

4. SOLAR EASEMENTS

Just as with light and air, a property owner has no implied right to receive the direct rays of the sun in order to utilize a solar heating system. Consequently, the adjacent owner must agree either to remove trees or natural growth to permit the passage of sunlight or to refrain from putting structures above a certain height on his property.

5. AVIATION (AVIGATION) EASEMENTS

This easement permits aircraft to fly low over property (normally in the course of landing at an adjacent airport). In addition to barring any legal action for damages because of the noise created by a low-flying aircraft, the easement may bar the landowner from building above a fixed height or may require him to trim trees already on the property.

6. WATER EASEMENTS

Ownership of property adjoining a pond, lake or river does not necessarily carry with it riparian rights (the right to use such waters). Depending upon local law, such waters may be owned by the public or may be subject to private ownership by another. In either case, the property owner's right to use the water may depend upon the existence of an easement.

7. SPORT OR RECREATIONAL EASEMENTS

The owner of property may grant to another (usually for a fee) the right to use the property for fishing, hunting, boating or other recreational purposes. These easements are sometimes known as "novelty easements."

8. PASTURE EASEMENTS

A common easement in the western United States is the right to use land for pasture. This permits a rancher to utilize large areas of land for raising livestock without owning the land.

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REAL ESTATE EASEMENTS

9. SUPPORT EASEMENTS

There are two types of support easements. The subjacent support easement is the right of a landowner to have the surface of his land supported by the adjoining land (i.e., the adjacent owner may not excavate his land to the point where his neighbor's land will collapse).

The other form of support easement is used in connection with air rights. An owner seeking to construct an improvement in his or her land may need the right to place the improvement on columns driven into the ground owned by another. Normally, such support easements will be included in the lease or deed creating separate rights in the air space.

10. DRAINAGE EASEMENTS

If land is subject to flooding due to excessive rainfall or the overflow of a lake or river, the owner may seek the right to construct a drainage ditch across the property of another. This problem also may arise where a large area is paved over (as in the case of a shopping center) so that the land is no longer capable of absorbing rainfall.

11. FLOWAGE EASEMENTS

In the same situation as just described, the owner of flooded land may seek the right to have the water flow over the land of another, perhaps temporarily flooding it. The adjacent owner may be willing to grant such a flowage easement if the land is unimproved or will otherwise not suffer from the overflow.

12. OVERHANG (ENCROACHMENT) EASEMENTS

If property is improved by a building that reaches to the property line, overhangs from the building (e.g., window air conditioners) may encroach upon the adjacent property. It may be necessary in such cases to obtain an easement so that title to the adjacent land will not be made unmarketable.

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LEASING: LANDLORD CANCELLATION CLAUSE

By Mark Puttick

A commercial rental market, as at present, affects the lease negotiating process in two significant ways. First, it offers the tenant an opportunity to obtain concessions that under normal conditions would not be granted by the landlord. Second, it changes the outlook of both parties about contingencies that can occur during the lease term.

Consider the owner of an office building who intends to sell when market conditions improve, whether that occurs in one year, five years or more. Or consider the owner of vacant under-improved property who plans to develop it whenever market conditions justify. In the meantime, the property must be leased to generate sufficient cash to pay operating costs and debt service on a mortgage. Such an owner will be amenable to granting significant concessions, including a favorable rental, provided the landlord can cancel the lease during the lease term.

One alternative to a long-term lease subject to cancellation is a series of short-term leases. However, a long-term lease subject to cancellation under specific conditions can be preferable to a tenant over a short-term lease that the landlord can refuse to renew for any reason. Some guidelines for drafting a fair cancellation clause are set forth below. For example, the option might be exercisable only in the event the property will be sold to a specified buyer. If the tenant would incur substantial costs to prepare the space for use, the tenant is likely to insist on some reimbursement if the lease were canceled. A common formula is to amortize the up-front costs over the lease term, with reimbursement to be the unamortized cost at the time of cancellation. An alternative method is for the rent to be set initially at a lower level and stepping up at periodic intervals. It should be clear when any such payment is to be made if the notice of cancellation is given, when the tenant vacates the space or otherwise.

If the landlord sells the property to a buyer willing to continue, leasing to the existing tenant so that no cancellation occurs, it should be clear the landlord need not make any payment.

Another alternative is right of first refusal. The tenant may seek a right of first refusal in the event of a proposed sale that includes a cancellation of the lease. This would give the tenant the right to match the offer of the buyer and so become the owner of the property. However, landlords dislike right-of-first-refusal because they complicate efforts to sell.

Finally, there is the right to cancel option, where the tenant may ask for a similar right to cancel the lease under certain conditions. The landlord, however, may be unwilling to agree to this because it makes it more difficult for the landlord to sell the property.

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DUE DILIGENCE: PURCHASE WITH CARE

By David Tevlin

WITH REAL ESTATE MARKETS UNDER PRESSURE, BUYERS ARE LOOKING FOR BARGAINS AND, IN SOME CASES, MAY BE TEMPTED TO CLOSE A DEAL QUICKLY BEFORE OTHER BUYERS APPEAR.

As a result a buyer may forego customary "due diligence" procedures, even to the extent of putting down a non-refundable deposit before a contract is signed. This could prove to be a costly mistake. Wholly apart from any unethical behavior by a seller, a property's physical condition and financial picture may turn out to be much different than expected upon close inspection after the title has passed.

▶WHAT IS DUE DILIGENCE?

Once a buyer has identified a particular property for purchase, the overall due diligence process generally consists of four steps:

- Making a physical inspection of the property and the adjacent area, with particular attention to possible environmental concerns
- Making a detailed examination of all leases to confirm rents and terms and to identify any provisions that might affect future cash flow, such as rent concessions, periods of free rent and below-market renewal options
- Preparing an investment analysis showing the potential return under different assumptions with respect to interest rates, occupancy levels, rents and expenses
- In some cases, entering into a letter of intent with the seller as a preliminary to detailed negotiations on a contract of sale

▶MANIPULATING CASH FLOWS

Professional consultants, such as accountants, attorneys and engineers, usually are retained to carry out the steps just described. An experienced investor, however, will want to be sure that particular attention is given to actions of the seller that (intentionally or not) have the effect of manipulating present or future cash flows. The sale price of a commercial property, such as an office or apartment building, is a multiple of current and future operating income. Any miscalculation as to either the current income or the rate of expected growth could mean the contract price is significantly above the value of the property. Some of the buyer's concerns about present and future cash flows are discussed below.

▶EFFECTIVE RENTS

The owner of an office building intending to sell within a short time period can utilize several techniques to increase the rent toll. For example, in the case of a new building still in the lease-up period, the owner might negotiate above-market rentals in exchange for above-market cash and improvement allowances given to the tenants. The allowances in turn can be hidden in the balance sheet. Proper due diligence by a buyer could mean appropriate access to rent figures.

▶ROLLOVER LEASE ASSUMPTIONS

A critical consideration for a buyer, particularly in a period such as now when market rents are often below contract rents, is the schedule of termination dates for existing leases. If a large number of leases are due to expire within the near future and before the market is likely to strengthen, the new owner will face a difficult decision as to whether to renew (or seek new tenants) at lower rates or permit the space to remain vacant until rents once again begin to rise. The present owner may have declined an opportunity to extend existing leases at lower rents in order to show a high level of effective rents until the property can be sold. While there is nothing unethical in doing so, a prospective buyer may obtain some negotiating leverage by pointing this out.

In addition, a buyer should challenge any renewal assumptions made by the seller about large space leases in the building. A major lease comprising 25 percent or more of a building that will expire within several years of the sale poses a substantial risk to the buyer since the existing tenant or another large user will have negotiating leverage.

▶OPTIONS AND RIGHTS OF FIRST REFUSAL

In the tenant-favorable market of the past few years, tenants often were able to obtain such concessions as options to renew at a fixed percentage discount from "market rates at time of renewal." This can be an invitation to a lawsuit at the time the renewal option is exercised and a buyer must consider how the exercise of such options will affect the income from the property. Similarly, a tenant may have a right of first refusal (RFR) on adjacent space in the event it becomes vacant during the lease term. Such RFRs can prove to be a serious obstacle to finding a new tenant, particular one seeking a large amount of space.

▶RETAIL REVENUES IN AN OFFICE BUILDING

Retail space on the main floor of an office building often is an important revenue source. An effective due diligence team will determine whether the existing retail uses are appropriate and provide the maximum profit opportunity. An owner anticipating the sale of the building may have entered into a lease with a fast food operation or other type of retail use likely to generate high short-term profits but that over the long run will detract from the reputation of the building. Alternatively, the owner may have installed a white tablecloth restaurant

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DUE DILIGENCE

to serve upscale tenants of the building but which pays below-market rent.

▶OTHER TYPES OF INCOME

Lobby space can be a source of additional revenue for the building by means of kiosks, ATMs, newspaper stands, shoeshine facilities and similar operations. If such income sources already are present, the buyer should question whether they add or detract from the image of the building. On the other hand, if lobby space is unused, consideration should be given to developing other such income sources.

▶PROPERTY TAXES

Property taxes are a major expense for an office building. A due diligence team should carefully determine whether the leases require tenants to absorb the cost of property tax increases, including those due to a higher assessment caused by a change in ownership. The present owner may have incurred a large amount of tenant improvement costs shortly prior to the sale that are not yet reflected in an increased assessment.

▶INSURANCE PREMIUMS

The failure to carefully examine the insurance coverage for a building could result in sharply increased insurance premiums for the purchaser. For example, if the present owner has a portfolio of buildings covered by a blanket liability insurance policy, a buyer must determine how the premiums have been allocated among the various properties. Since the owner typically can allocate the premiums in any way desired, the premium allocated to the building in question may be much lower than if an individual policy is obtained. In addition, a proper due diligence investigation will determine whether the insurance provider has a satisfactory rating, as well as the loss history of the building.

The foregoing illustrates some of the issues to be resolved by appropriate due diligence when purchasing a commercial property.

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LAND PURCHASE-LEASEBACKS

By Wing Leung

For passive investors, land purchase leasebacks are attractive in an economic environment such as now, when the outlook is for low inflation and limited (if any) growth. Buying land already improved or that is about to be improved offers no depreciation deductions or other tax shelter and carries a small (if any) return. On the other hand, well-located land is a very desirable commodity because of its permanence, the priority of its claim to rent and its long-term appreciation prospects (provided the ground lease is carefully drawn).

Traditionally, investors in land purchase leasebacks have been pension funds, educational institutions or other investors with no need for tax benefits. However, private investors with a long-term outlook (particularly in connection with family trusts) have built substantial fortunes in the past through the ownership of land subject to long-term ground leases.

A common use of land purchase leasebacks is to aid in financing new construction. Developers who sell land they own and then lease it back can reduce their equity requirements, since construction costs can then be fully financed with a construction loan. Furthermore, the ground rent paid to the landowner is fully deductible, whereas mortgage payments are deductible only to the extent they represent interest rather than loan amortization, and owners cannot depreciate land for any purpose.

▶REFINANCING USAGE

The other typical use of land leasebacks is in connection with the refinancing of income properties that require extensive renovation or that are being converted to a different use. By utilizing a land sale leaseback, the property owner generates new capital at a lower cost than mortgage refinancing because the anticipated appreciation in the land value will add the return to the land purchaser. At the same time, the seller-lessee retains depreciation write-offs and can fully deduct the land rent.

When analyzing a land purchase leaseback, the investor's primary concern is to calculate the initial yield as well as the internal rate of return (IRR) over the projected holding period. Ground rent may be 2 percent or 3 percent below the interest rate on a long-term fixed-rate mortgage, although this may not be the case with today's unusually low rates. The land-purchaser accepts the lower initial return expecting to benefit from the land appreciation over the life of the lease. In addition, ground leases usually provide for rent increases tied to periodic reappraisals of the land. If the fee interest is subordinate to a mortgage taken out by the lessee (see below), then land, rent and IRR should be several percentage points higher to reflect the additional risk.

The landowner's interest is not subordinate to the claims of any other party, and the right to the ground rent takes priority over all other private interests. The picture is different, however, if the landowner voluntarily subordinates the fee interest to a mortgage taken out by the ground lessee. This often is necessary if the ground lessee is to obtain construction financing to put up an improvement. In that event, the mortgage covers both land and building, so that a default by the lessee requires the landowner to cure the default or risk a foreclosure against the ground lessee.

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