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REAL ESTATE MONITOR

DUE DILIGENCE IN REAL ESTATE ACQUISITIONS

By Wing Leung

One of the most familiar terms in real estate in connection with the purchase of real property is due diligence. "Due diligence" means conducting an appropriate investigation into the legal rights and encumbrances, physical structure, and financial operations of the real property to be acquired by the purchaser. The object is to find out all about the property by relying on all sources of information. What amount of diligence is "due" depends upon the circumstances, including the risks created by the prior use of the property, the monetary value of the transaction, and the available budget. Ultimately, the process should provide the acquirer with a reasonable level of confidence that they are aware of all material items affecting the property including those matters not disclosed to the buyer. For instance, the seller may not be aware of certain zoning rights and easements if the seller operated the property with no intention to redevelop the property, but the buyer intends on demolishing the existing facility to construct a larger complex.

Purchasers of real property often outsource pieces of the process to professional consultants including accountants, attorneys and engineers. The purchaser or its financial analyst often prepares an investment analysis showing the potential returns from the asset with a sensitivity analysis employing varying interest rates, terminal cap rates, occupancy levels, rents and expenses. The increased use of complex legal and financial structures, such as securitized lending, and increasingly complex regulations have made the process of validating interests in real estate more complex and thus further necessitation of use of outside service providers. The type of investigation that a buyer should perform in any real estate transaction also depends upon the type of property being purchased.

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The buyer want to verify what seller is selling. For example, real estate developers often provide easements to utility companies. An easement may cause difficulty later if it runs through a part of the property which the buyer plans to build. An adequate due diligence would uncover this matter and provides the buyer an opportunity to change the location of the easement before the signing of the contract. The buyer or its lawyer will usually order a title report. This will disclose who owned the land and the owner's precise legal interest in the land. It confirms that the buyer is indeed dealing with the property owner and that the legal description of the property matches the deed. It will also confirm the zoning of the property.

The due diligence process also entails a physical inspection of the asset and the adjacent area and considering environmental risks that differ depending on the location and prior use of the asset and the plans for the property (e.g. development versus continuing operations). Generally, when the acquired property is an income producing property, conduct a detailed examination of the property's financial records including lease agreements, invoices and contracts. It is not unusual for purchasers to have skipped or limited this procedure in a "seller's market" or for highly sought-after real estate assets when sellers are able to limit the scope of information provided to the buyer. It is rarely recommended for buyers to skimp on this step especially considering the value of an income producing property is typically affected most by its income potential rather than its development potential.

By conducting due diligence a buyer can identify and tackle many practical and legal problems before closing when all parties are most inclined to work together to resolve such issues rather than after the transaction closes.

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EURO REAL ESTATE

By Mark J. Puttick, Senior Associate

That the Eurozone remains in turmoil is evident. Unemployment figures across the continent remain stubbornly high with youth employment at troublingly low levels in certain countries. This is only one aspect of the current economic climate making governments, central banks and investors skeptical of any forecasts of economic growth in the medium term.

For real estate investors, the lack of economic growth expected in the region poses a problem: economic growth is good for capital asset values and optimism, which make real estate investors' old dream of "buy low, sell high" easier to achieve. So what should real estate investors do when this process is not functioning? Before considering a solution, there is one more problem.

The unwillingness of banks to lend on real estate assets outside of three or four "core" locations in the Eurozone is contributing to low levels of GDP growth and constraining the value of real estate assets. This is the opposite of the bubble that burst six years ago, where too much credit led to price insensitivity and therefore unsustainable inflation of asset properties. The lack of debt not only means the total capital targeting assets is lower, but also that the ratio of equity to debt in each deal is higher, which, in the opposite world of credit over supply, makes investors more price sensitive. It would seem we care more about our own money.

In any case, these two problems (expectations of low growth in asset values and lack of debt finance) are being linked together by certain real estate players to create new opportunities. Both serve to make the debt side of deals more interesting at present; investing in traditional senior notes when asset prices are rocketing makes the equity side more appealing, but this is not happening. Yet capital still requires deployment, and the lack of lending from traditional players creates an undersupply of credit that results in borrowers' willingness to pay an interest rate premium.

By May 2013, there were already 19 Europe-focused debt funds in the market targeting aggregate commitments of approximately $12.8 billion, and in the months since that report, several other similar funds have been announced. That compares to seven funds with an aggregate target of approximately $2.9 billion just a year earlier. That growth clearly shows the funds are taking note. But the total of all those funds is a mere drop in the ocean when one considers that somewhere in the region of $1.6 trillion of real estate lending in Europe will require refinancing in the next four years. That is approximately one hundred times the cumulative value of the capital contributed to those 19 or so funds. Naturally, in this environment, borrowers are concerned about being able to refinance successfully and are paying a premium to do so. Some debt funds are solving this problem by lending (at a premium, of course), others by buying borrowers out of distressed positions (at a discount, naturally). In both of these scenarios, the private equity holds the advantage. Investors can see this, too, which is perhaps why funds have been able to announce a launch and attract capital commitments so quickly. Of course, this is all happening in the broader context of a low-yield environment, so the potential returns offered by these funds are attractive to investors who like real estate but are rightly skeptical of a conventional asset play in Europe at this time.

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LEASE MODIFICATION: IN RECESSIONS

By John Tax, Director – Real Estate Services

A tenant with excess space due to weak business conditions and with a lease having years to run may be under pressure to reduce rent payments. If the tenant had been able to obtain a space rent reduction provision in the lease, it might have provided a solution. However, even without this, several alternatives can make a downsizing possible. For example: (1) lengthening the lease term; (2) buying out or restructuring the remaining lease term; or (3) subleasing the unneeded portion of the space may provide the needed relief.

▶LENGTHENING LEASE TERM

In a situation where the tenant is satisfied with the location but seeks only to reduce the amount space, the landlord may agree to reduce the square footage in exchange for an extension of the primary lease term. The tenant might be able to negotiate the same rent per square foot or may be able to reduce it further depending on the particular circumstances.

▶BUYING OUT OR RESTRUCTURING THE LEASE

<PF>A tenant buyout or cancellation of the lease may be possible. The tenant must be prepared to offer a significant sum to the landlord in exchange. The payment will reflect the landlord's unamortized costs in preparing the space plus an amount reflecting the loss of rent until another tenant takes the space. If rents in general have increased since the original lease began, the landlord may agree to terminate the lease for a smaller sum in anticipation of finding a new tenant at a higher rental cost.

During an economic downturn or a period of weak business, a tenant may seek to reduce the rent by one means or another until conditions improve. If downsizing is not an alternative or is not desired, the tenant can seek to renegotiate the lease so the current rent is reduced but will be stepped up during future years so that the landlord comes out financially ahead by the end of the lease term. At a time when new tenants are hard to find, a landlord may agree to such an arrangement in order to retain the tenant. The revised lease can be more acceptable to the landlord if the tenant agrees to extend the term for additional years.

▶SUBLEASING EXCESS SPACE

Another alternative for the tenant is subleasing the excess space. However, even assuming the lease imposes no restriction on the right to sublease, a sublease should be considered only when other alternatives are unavailable. A tenant that subleases becomes a landlord and assumes the responsibilities of that position, including marketing and leasing expenses, brokerage commissions, dealing with tenant improvement costs, overseeing alterations and enforcing the sublease in the event of a default by the subtenant. The original tenant remains fully liable for obligations under the original lease. Approval by the landlord of the sub-lessee may also be necessary.

A valid sublease makes no change in the relationship between the landlord (lessor) and the original tenant (prime lessee) and creates no relationship between the lessor and the sublessee. The prime lessee remains liable to the landlord for any breach of the prime lease, whether the breach is by the prime lessee or the sublessee. The landlord cannot collect rent directly from the sub-lessee, and the sublessee cannot bring an action to compel the landlord to comply with any obligations under the prime lease. Any default by the lessee under the prime lease that results in a termination of the prime lease by the lessor automatically results in the termination of the sublease.

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TAX DEDUCTION: HOME OFFICE

By David Tevlin

A deduction for home office expenses is allowed when a specific part of the home is used "exclusively" and "on a regular basis" as the taxpayer's principal place of business. Code Section 280A(c)(l)(a); IRS Publication No. 587. A home office will be treated as a principal place of business if it is used for administrative or management activities of any trade or business of the taxpayer, but only if there is no other fixed location where the taxpayer conducts substantial administrative or management activities of that trade or business.

▶OPTIONAL SAFE HARBOR DEDUCTION METHOD.

Starting in 2013, the safe harbor allows an individual to multiply the number of square feet used for the home office by $5.00. The maximum number of square feet is 300 so that the maximum deduction is limited to $1,500. (Rev. Proc. 2013-13, 2013-6 I.R.B. 478).

▶PLANNING STRATEGY

It may not always be a good idea to claim any depreciation for the home office. Depreciation claimed reduces the amount of gain eligible for the $2000 home sale exclusion ($500,000 for a married couple filing jointly).

Commuting Expenses From the home Office. If the residence is the taxpayer's principal office, expenses incurred in traveling between the residence and another work location are deductible. Rev. Rul. 99-7.

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LANDLORD/TENANT: RETALIATION; NO SHOWING OF MALICIOUS INTENT

By Alvin Arnold

Many states have statutes or cases prohibiting a landlord from retaliating against a tenant who complains to government officials about housing conditions, discrimination or other issues. One problematic issue that often arises, however, is whether a landlord's act was "retaliation" or simply a business decision independent of the complaint. Whether the tenant must prove malice or harmful intent by the landlord is unclear in many jurisdictions. In a recent case, the Oregon Supreme Court held that tenants can prevail on a claim of retaliatory eviction despite their failure to prove that their complaints injured the landlord or that the landlord had malicious intent in evicting them. Elk Creek Management Co. v. Gilbert, 2013 WL 2370592 (Or. 2013).

▶FACTS

Tenants held a month-to-month tenancy under a written rental agreement. They made some complaints to the owner about the electrical system on the property, and the manager and owner did a walk though to see the extent of the problems. It was clear that work needed to be done. The next day, the manager called the tenants and told them that the owner had decided to terminate their lease, providing a written 30-day termination notice. No evidence on the reason for the termination was ever provided, except for a statement in the termination notice that the owner "has several repairs including updating the electrical."

▶LOWER COURTS

The trial court concluded that the tenants had failed to prove retaliatory eviction by the landlord, noting that retaliation generally refers to a party who has suffered an injury inflicting similar injury on the other party. Here, there was no evidence that the complaint had harmed the landlord or that the landlord felt aggrieved, or that the landlord had terminated the tenancy with the intention of harming the tenants. In fact, the evidence showed that the landlord had previously spent considerable sums on repairs, and had had taken no action against the tenants on a previous occasion when they fell behind on their rents.

The intermediate appellate court affirmed, noting that retaliation "involves an intention on the part of the landlord to cause some disadvantage to the tenant, motivated by a injury (or perceived injury) that the tenant has caused the landlord."

▶CAUSATION REQUIRED, BUT NOT MALICIOUS INTENT

Supreme Court Reversal

The Oregon Supreme Court reversed, finding that the statute at issue did not require any harm (or perceived harm) to the landlord, nor any intent to harm the tenant. The statute prohibits "retaliation by" a landlord "after" a tenant has taken some act to enforce his or her legitimate rights. It does expressly address the mental state required or the level of causation that must be proven. (For example, some states have prohibited eviction that is based "solely on" retaliation for a tenant's act.) The trial and appellate courts had read an intent element into the word "retaliation," but the state Supreme Court disagreed.

While noting that the common definitions of retaliation involve some intended repayment of a harm or injury, the court wrote that the word had to be interpreted in the context in which the statute was passed. The statute was intended to advance two related interests: that tenants assert their statutory rights, and that landlords fulfill their statutory obligations. "It would be inconsistent with those interests for the legislature to impose a requirement that the tenant provide that his or her exercise of those rights caused the landlord injury."

<P>Moreover, the statute was derived from the Uniform Residential Landlord and Tenant Act, and originally included the provision from that act stating that if the landlord took specified actions within a specified period after a tenant exercised his rights, there would be a "disputable presumption" of retaliation. The court noted that the URLTA had adopted a statutory formulation close to the test used by New Jersey, where the case law had established that a tenant did not have to prove the landlord's malice or hostility, implying that this was the standard intended by the Oregon legislature. Moreover, this is the standard used in various other statutes prohibiting various types of retaliation (for example, by employers).

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PErspective in Real Estate

As discussed in the last issue of PErspective in Real Estate, private equity funds continue to have a strong appetite for the real estate sector. At the same time, however, they are facing challenges when it comes to identifying compelling investment opportunities. With the U.S. market finally returning to "normal," many private equity funds are turning their attention abroad to find real estate opportunities that are more attractive when it comes to pricing. Europe, Asia and Latin America are all representative of this trend - with many firms focusing on investing and raising funds in these markets.

- Europe's distressed real estate environment is increasingly becoming a target for private equity investments, as evidenced by H.I.G. Capital's recent deal to buy the majority stake in Project Bull, a portfolio of foreclosed properties located throughout Spain valued at $133 million. Countries like Spain, while still working to emerge from the financial crisis, are showing preliminary signs of life in their real estate markets. And as fears about the euro zone dissipate, investors are showing increased interest in deeply discounted properties that are forecasted, albeit tentatively, to rebound over the long-term.

- China is also reentering the radar of many private equity firms, after runaway housing prices curbed their appetite for real estate opportunities in the country during the past several years. Today, however, investors are poised to resume their investment activity as the central government has loosened its controls on the real estate sector. In fact, overseas-based real-estate managers have raised $1.6 billion in funds for residential property investment in China during 2013, according to Preqin. That's significantly more than the $800 million raised in 2012 and the $400 million in 2011.

- Latin America is also in the spotlight as an emerging market for real estate investment. According to a recent survey by Preqin, fundraising for the Latin American real estate market is set to surpass 2012 levels with a record number of funds currently raising capital. Strong economic growth and an expanding middle class in many Latin American countries is likely contributing to this trend, particularly in Brazil, which accounts for 66 percent of total capital sought within the region.

PErspective in Real Estate is a feature examining the role of private equity in the Real Estate Industry.

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