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REAL ESTATE MONITOR

STORING CAPITAL IN AN ASSET CLASS

By R. Christian Sonne, MAI, MRICS

Capital flow, both equity and debt, continues to find superior returns in the self storage sector. Based on total returns by property sector published by NAREIT, self storage outperforms other core sectors such as apartment, office, retail, industrial and office with five-, 10- and 15-year returns of 18.85 percent, 20.48 percent and 16.54 percent, respectively.

Continued gains in cash flow have sustained confidence throughout 2013. For example, as of Q2 2013, asking rents in self storage are up 1.1 percent over the prior year, physical occupancy is up 2.6 percent over the prior year and rental income (collected rent) is up 4.1 percent over the prior year. Such a robust performance in terms of occupancy and income is a function of strong market fundamentals with respect to supply and demand. As of last quarter, there were only 30 “new start” projects nationwide and only 123 nationwide over the prior four quarters. Based on a total stock of approximately 46,000 facilities, new supply is nominal (reported in the Self Storage Performance Quarterly).

The Self Storage Industry Group at Cushman & Wakefield tracks data on over 8,500 facilities in the U.S. every quarter, with a concentration on the top 50 MSAs, reflecting a sample size of 18.8 percent of all facilities, but 49.2 percent of facilities in the top 50 MSAs. These patterns of growth have continued over the past three years, after the hangover from the recession bottomed out mid-year 2010.

As a result, acquisitions have remained robust with over $2 billion in portfolio acquisitions over the past year or double the pace of

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STORING CAPITAL

the prior two years. For class A product, self storage cap rates are generally 6.5 percent or less. Portfolio premiums are commanding reductions of 100 basis points or more in cap and yield rates. Leading the charge in acquisitions are self storage REITs, non-publicly traded self storage REITs and national investors. New to the party are "crossovers," such as buyers from the apartment sector, who like the superior returns of self storage with low-cap expenditures.

Investors are being more selective, segmenting cap rates by investment quality. For example, a class A facility (physical and investment quality) can vary by 175 basis points compared to a class C facility. More detailed data from the survey results demonstrates market segmentation:

Class C is defined as:

- Secondary, less-desirable locations with generally poor access and limited visibility
- Construction quality ranges from fair to average
- Maintenance ranges from fair to average with minimal or no security
- Generally managed by the owner and may not have an on-site manager.
- Typically older facilities with growing functional and/or economic obsolescence

Over the last five years, investor analytics have increased. Discounted cash flow analysis is the preferred methodology as a result of revenue enhancement models. For self storage, street or asking rental rates change at a slower pace than actual rents in place. As the cost and use of concessions decline, actual or collected rent continues to rise. With the ability to raise rents at any time on monthly contracts (not leased fee), collected income continues to grow.

Looking ahead, domestic self-storage performance metrics are forecast to remain strong. Cap rates are forecast to continue to decline, even as acquisitions increase.

MARKET SEGMENTATION BY INVESTMENT QUALITY

	Class A	Class B	Class C
Discount Rate (IRR):			
Range:	8.5% - 9.5%	9.0% - 10.0%	10.0%-11.0%
Average:	9.00%	9.50%	10.50%
Capitalization Rate:			
Range:	5.75% - 6.75%	6.25% - 7.50%	7.50% - 8.50%
Average:	6.25%	7.00%	8.00%
Residual Cap Rate:			
Range:	6.0% - 7.0%	6.50% - 7.75%	7.75%-8.75%
Average:	6.50%	7.50%	8.25%

Class A is defined as:

- Located in one of the top 50 MSAs, usually with high barriers to entry
- Excellent location and access to attract tenants willing to pay rents in the upper percentile in the marketplace
- Superior construction and finish
- Characterized by above-average maintenance and security
- Professional on-site and off-site management

Class B is defined as:

- Average location, access and visibility
- Construction quality ranges from average to good
- Maintenance ranges from average to good
- Security ranges from average to good
- Full time on-site and competent off-site management

R. Christian Sonne, MAI, MRICS is Executive Managing Director of Cushman & Wakefield's Self Storage Industry Group, a nationwide real estate consulting team specializing in appraisal and research of the self-storage asset class. Chris.Sonne@cushwake.com

PERKS, PITFALLS OF M-U PROPERTIES

By Stuart Eisenberg, Partner & RE Practice Leader, BDO USA, LLP

As people increasingly choose to live, work and play in centralized locations, developers and investors are taking advantage of this trend by building more mixed-use properties. These properties can be extremely profitable as their various sectors—retail, office, residential—build in a set customer base for each other and can have a positive impact on the town. To that end, some governments have taken note and, thus, have decided to provide monetary incentives for developers to build mixed-use properties. However, these projects can be challenging and without the right market analysis, planning and team in place can be subject to a number of pitfalls.

GROWTH IN SECONDARY, TERTIARY MARKETS

Identifying locations with the right tenants available, meaning people interested in living in mixed-use properties that can also support the commercial component, is often vital to a mixed-use development's profitability. Cities, with their limited space and naturally close quarters, have been longtime targets for these types of properties. Many developers are now looking to build in secondary and tertiary markets, catering to a suburban population with the desire to have the convenience of urban centers. This is creating an opportunity for the development of mixed-use properties across the country. Florida, in particular, is a hot spot for this type of real estate activity, with centers like Boca Raton's Mizner Park popping up with increasing frequency.

BENEFITS FOR ALL

While people may find the convenience of mixed-use properties appealing, local communities and developers are benefiting as well. Strategically choosing complementary tenants can help drive traffic and, as a result, boost local economies. As a result, the community has a vested interest in the success of these projects.

Many local governments, particularly in depressed areas, provide debt financing or favorable tax incentives to support these real estate initiatives. These governmental perks can often be substantial.

▶ASKING THE RIGHT QUESTIONS

While mixed-use properties can be profitable, they can also be exposed to the volatility of each real estate market they touch. If one sector fails, then others can be adversely affected. Thus, it is crucial for developers and investors to take a number of considerations into account before diving into any project. A thorough risk analysis of the local markets and demographics must be done to ensure that the property and tenants will be competitive. Plans for a profitable blend of tenants, along with the appropriate corresponding infrastructure, should be in place. Since different sectors of tenants have various needs during both the development and operation stages, assembling an experienced management team that can work together is fundamental. It is also important to keep in mind that securing financing for mixed-use properties can be complex since, for borrowing purposes, the buildings are typically considered commercial developments and, therefore, may be subject to lower loan-to-value ratios and to higher loan rates than single sector developments.

Mixed-use properties are attractive to people looking for the convenience of a central location and to local communities that can benefit from the increased traffic they generate. While developers and investors may be smart to capitalize on this growing trend, in order to be successful, they must be sure to go through an extensive research and planning process to test the market's appetite, overall risk exposure and, ultimately, determine the feasibility of such a project in that particular location.

Stuart Eisenberg is a Partner and National Real Estate Industry Practice Leader at BDO USA, LLP. He can be reached at 212-885-8431.

GROUND LEASES: INTERMEDIATE RENTALS

By John Tax, Audit Director, BDO USA, LLP

In an uncertain real estate market, owners of property may not be willing to enter into a long-term rental or current sale at current prices. If this occurs, the ground lease may be an alternative. In such an arrangement, the tenant agrees to pay all taxes and maintain the property in good condition. Ground leases usually run for 10 or more years and can run upwards of 99 years. This permits the lessee, such as a supermarket, restaurant or other retail properties, the incentive to make major improvements. The ground lease can also specify that at the end of the lease term, the ground lessee has an opportunity to purchase the property at a price set by the current market value for the specific property.

▶CONSIDERATIONS

The ground lease tenant usually is required to pay all expenses, such as taxes, insurance, maintenance and necessary repairs, during the term of the lease and is referred to as a net lease. The actual conditions of the lease can vary, depending on the agreement between the property owner and lessee. The terms of the lease dictate what happens to the improvements at the end of the lease term, which might give the landowner rights to the buildings, allow the tenant to remove the improvements or give the landowner the option to purchase the improvements.

▶BENEFIT

The major benefit for the property owner is the ability to retain ownership of the land and earn revenue from the property, without the expense of developing the land. Since it is typically a long-term lease, the property owner has a tenant locked into a commitment for a long period. At the end of the lease term, the property owner may reap the benefits of whatever improvements the tenant made to the land.

▶FUNCTION

Ground leases are often commercial leases, giving lessees a way to build a business without the expense of purchasing land. Governments sometimes enter into ground leases when constructing public buildings. This allows them to construct buildings, such as libraries, when public land is not available and purchasing real estate is unaffordable.

▶USES

An entity that owns land, yet is not in a position to sell the property, often uses ground leases as a way to generate income from a property. This might be public land or tribal lands. For example, the Federal Bureau of Land Management often enters into ground leases with concessions to develop resort areas.

John Tax is a Director of the Real Estate Practice in BDO's New York Office. He can be reached at 212-885-8027.

IMPACT OF TANGIBLE PROPERTY REGULATIONS ON REAL ESTATE COMPANIES

By Marla Miller, Director, BDO USA, LLP

On Sept. 13, 2013, Treasury released the highly anticipated final tangible property regulations. These regulations will affect virtually all taxpayers that acquire, produce or improve tangible property. Real estate companies have many expenditures, including acquisitions, upgrades, remodels and repairs, which will be subject to this new guidance. These new regulations will likely have an impact on the tax accounting for these costs.

▶BACKGROUND

The new regulations have been in the works for almost a decade and are now available in final form. The regulations generally are effective for tax years beginning on or after January 1, 2014.

▶MAJOR PROVISIONS

One of the most widely applicable provisions in the regulations is the tax treatment of improvements made to tangible property. The regulations provide a general framework for determining whether an expenditure is an improvement to property that must be capitalized, or a deductible repair expense. Determining the relevant "unit of property" (UOP) is important because it is the reference point for which all capitalization standards are applied. That is, what is the item being repaired or improved? The smaller the UOP, the more likely an expense will be treated as a capitalized item, rather than a deductible repair expense.

The new regulations define the UOP for real property as the building and its structural components. However, when applying the capitalization rules, each "building system" constitutes a separate UOP from the building structure. For purposes of the capitalization analysis, the UOP for a building is:

- The building structure (walls, roof, windows, doors, etc.)
- Each building system (High velocity air conditioning (HVAC), plumbing, electrical, escalators, elevators, fire protection and alarm, security and gas distribution)

Taxpayers must determine whether an improvement was made to the HVAC system or the elevator system, rather than the building as a whole. This smaller UOP will likely result in more capital expenditures. The regulations also provide detailed rules for determining the UOP for condominiums, cooperatives and leased property.

Once the UOP is determined, the improvement standards must be applied. The regulations require a taxpayer to capitalize amounts paid to improve a UOP if the amount results in a "betterment," "restoration" or "adaption." The regulations provide a facts and circumstances test for determining capitalization requirements and provide many examples illustrating how to interpret and apply these rules. Opportunities may remain to deduct repair expenditures under these new regulations that companies often capitalize and depreciate.

The regulations for dispositions were released in proposed format. The definition of dispositions includes the retirement of a structural component of a building. A taxpayer can dispose of an old component upon replacement, such as a roof or HVAC replacement, resulting in a recognized loss for the undepreciated cost of the old component. Final regulations are anticipated in early 2014.

While this article focused only on real property provisions, there are many other provisions in the regulations that taxpayers should be mindful of, including revised rules for materials, supplies, spare parts, de minimis rules and investigatory and acquisition costs, among others.

▶WHAT THE NEW REGULATIONS MEAN FOR TAXPAYERS

Taxpayers should assess conformity of their current tax policies and procedures with these new regulations. Many of these changes will cause book/tax differences. Taxpayers should also review their current processes and information systems to make certain that necessary information is being captured. Lastly, complying with the new regulations will likely require many taxpayers to change their current methods of accounting. There are many opportunities and some pitfalls in these very comprehensive regulations. Taxpayers should carefully review this new law and consider how they will be affected.

Marla Miller is a Director in the Fixed Asset Advisory Services Group at BDO USA, LLP. She can be reached at 215-636-5520.

PErspective in Real Estate

Private equity firms are betting big on the housing market. In the past, the typical "home flipper" has usually been considered an amateur investor who taps a home equity line or savings for an investment property; today, numerous private equity firms and hedge funds are crowding into this space. They purchase single-family homes – often foreclosed on or heading that way – and either convert them into rental properties or refurbish them to sell for a quick profit.

According to The Wall Street Journal, market experts estimate that private equity and other investors have raised $6-$8 billion to invest in single-family homes. Many of these investors have partnered with local real estate companies to purchase, sell, lease and manage these properties. Blackstone Group LP, through its subsidiary Invitation Homes, is the biggest investor in this space, acquiring 41,000 homes in the past two years, according to Bloomberg.

This trend reflects the shifting number of home owners versus renters, over the last few years. Since the 2008 financial crisis and the rollout of stricter mortgage loan requirements, an increasing number of Americans are choosing to rent homes.

Private equity's interest in this market is not without controversy. Housing advocates have voiced concern that private equity firms, in conjunction with other investors, may result in increased rental prices due to a lack of competition. Other than its price impact on the real estate market, these investments often pose operating and managing challenges, as, unlike multi-family and office buildings, they are not localized in one place.

Furthermore, there is the concern of aligning the short-term investment cycle of private equity with that of real estate, which tends to be longer term. Despite concerns, many see private investment in the single-family home rental market as positive, since it has the potential to lift property values, fix damaged, vacant houses and fill them with tenants. Proponents include President Obama, who in August 2013 praised institutional investors for helping to stabilize real estate values in neighborhoods that have been devastated by foreclosure, according to CNNMoney.

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

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CONTACT:

ALVIN ARNOLD
Editor, Real Estate Monitor
212-885-8235
aarnold@bdo.com

People who know Real Estate, know BDO.