

THE NEWSLETTER OF THE BDO REAL ESTATE INDUSTRY PRACTICE

REAL ESTATE **MONITOR**



COULD MILLENNIALS' BELIEF SYSTEM BUILD NEW CRE FUTURE?

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

By 2025, Millennials are expected to occupy 75 percent of the workforce, and it is estimated that by 2015 they will have a combined purchasing power of \$2.45 trillion worldwide. As this generation, which has been dubbed the "consumers to change it all," comes to wield a substantial amount of purchasing power, monumental shifts could occur in commercial real estate (CRE).

Why does this generation stand to completely change the CRE landscape? It could be attributed to the digital revolution that Millennials grew up in and that forever transformed society. This era of radical innovation molded a new Millennial behavior set and belief system that is worlds apart from previous generations. Some of the most notable Millennial viewpoints disrupting how

this generation works, lives and plays, and that could eventually impact CRE, include:

- **Urban not Suburban Living:** Millennials favor living at the intersection of where they work, live and play. Nielsen reports that 62 percent of Millennials indicate they prefer to live in the type of mixed-use communities found in urban centers, "where they can be close to shops, restaurants and offices." This preference could be driven by many Millennials' decision to delay marriage and children. Just 22 percent of Millennials are currently married, according to Pew research.
- **Digitally Driven Living:** Tethered to their devices, Millennials are sleeping with their smartphone, and according to Nielsen,

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MILLENNIALS' BELIEF SYSTEM

83 percent literally do. With the ability to work, live and play essentially anywhere at any time, this generation's always-on nature could prove to have a profound impact on CRE, especially on office space.

- **Residents of the World:** Flexibility and freedom are at the heart of Millennial living. Their desire for a more nomadic lifestyle could play a part in their preference for renting not home ownership.

So what CRE sectors could experience the greatest transformations as a result of the Millennial value system? A few examples include:

- **Office:** As Millennials increasingly opt to live in densely populated and energetic urban centers, as well as work from and near their homes there could be a dramatic shift in how office space is utilized. For example, there could be the collapse of the suburban office park and erosion of new office development.
- **Retail:** While arguably the most technologically savvy generation, Millennials still rather shop in-store – according to a new study by OpinionLab, Millennials prefer shopping malls over shopping carts. However, to develop the more personalized and seamless shopping experience Millennials long for, brick-and-mortar retailers are reshaping their physical space to offer more of an experience.

- **Industrial:** While studies have shown Millennials have a penchant for in-store shopping, they still rely on e-commerce. Jones Lang LaSalle's Millennials Outlook cited that, "By 2020 they (Millennials) will account for 30 percent of (online) retail sales." This growing use of e-commerce could power an increased movement of goods that could require more fulfillment and distribution centers ultimately leading to a more vibrant industrial sector.

- **Residential Development:** Historically disenchanted with home ownership, many Millennials continue to rent versus buy. This preference may be more a result of economic circumstance than intent, as Millennials have faced high unemployment, high barriers to credit, and substantial debt stemming from the rising cost of education. And while the financial tides are turning as the economy recovers and provides Millennials more opportunity for home ownership, their preference for the freedom and flexibility renting affords may continue to outweigh the American dream.

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IMPACT OF NEW TANGIBLE PROPERTY REGULATIONS ON THE REAL ESTATE INDUSTRY

By Marla Miller, Senior Tax Director,
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In September 2013, IRS released final regulations ("Regulations") dealing with repair and capitalization of tangible property under IRC Sec. 162(a) and 263(a) and regulations relating to dispositions under IRC Sec. 168. These Regulations are effective for taxable years beginning on or after January 1, 2014. Every taxpayer with fixed assets is affected by these new rules; owners of real property are especially impacted. The Regulations are adopted through elections where indicated in the Regulations and by filing Form(s) 3115, *Application for Change in Accounting Method*, as indicated by the IRS in separate guidance.

METHOD CHANGES

A Form 3115, *Application for Change in Accounting Method*, is generally filed with a retroactive catch up adjustment that is the difference between the deductions claimed to date under the old method and the deductions that should have been claimed to date under the new method. Those owning or leasing real property will typically be required to file method change #184, which would include the following:

1. A change in the unit of property ("UOP") definition for applying the improvement standards (e.g., adopting the nine building system UOPs instead of the entire building UOP).
2. Adopting the routine maintenance safe harbor method change, the taxpayer must reasonably expect to perform the activities more than once during a 10-year period for real property and more than once during the Alternative

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TANGIBLE PROPERTY REGULATIONS

Depreciation System class life of the UOP for personal property. Making the method change provides audit protection.

3. Deduction of repair and maintenance expenditures that have been historically capitalized or capitalizing expenditures that have been historically deducted not in compliance with the final regulations. A taxpayer will be required to capitalize expenditures if there is a betterment, restoration, or adaption.
4. A change to an accounting method that is not in compliance with the Regulations, in a case where an accounting method change was previously filed under the temporary or proposed regulations.

The Regulations also provide for a new partial asset disposition election. Starting in 2014, taxpayers may elect to recognize a gain or loss on partial dispositions of a building that occur during the current year. For tax year 2014 only, taxpayers may file method change #196 to make a late partial disposition election and recognize a gain or loss on partial dispositions occurring in a prior year where the basis is still capitalized and depreciating.

SMALL BUSINESS RELIEF

The IRS recently released Revenue Procedure 2015-20, which provided relief to simplify the procedures for small businesses making accounting method changes. A "small business" is defined as a trade or business with average total revenues for the prior three years of not more than \$10 million or total assets of not more than \$10 million. If either of these tests is met, then a taxpayer may adopt the Regulations through these simplified procedures. For tax year 2014, the new guidance allows small businesses to change a method of accounting on a prospective basis without filing a Form 3115. Further, there is no calculation of a catch-up adjustment. No formal election or statement is required on the return. However, the IRS has recommended that small business taxpayers attach a statement reflecting that they are either implementing or opting out of the simplified procedures. There is no audit protection for pre-2014 years under the simplified procedures. Also, the late partial asset disposition method change is not permitted.



ELECTIONS

There are three new elections in the Regulations that each taxpayer should consider making.

De Minimis Expensing Safe Harbor

The Regulations introduce the De Minimis Safe Harbor which permits a taxpayer to currently deduct otherwise capital expenditures where:

1. The organization has a capitalization policy in place at the beginning of the year specifying that amounts incurred for the purchase of tangible property beneath a fixed dollar amount will not be capitalized for financial accounting or tax purposes;
2. The capitalization threshold cannot exceed \$5,000 for audited financial statements or \$500 if the organization's financial statements are not audited; and
3. The policy must be in writing if the organization has an audited financial statement.

Small Taxpayer Safe Harbor

The Regulations provide an election for a simplified repair versus improvement analysis for small taxpayers. A small taxpayer for purpose of this election is an organization with average annual revenue for the prior three years of not more than \$10 million. Taxpayers meeting the revenue threshold may expense

costs to repair, improve, or maintain building property(s), if those expenditures in aggregate, per building, do not exceed the lesser of \$10,000 or two percent of the original building cost. This simplified analysis may be applied to each building a small taxpayer owns that has an original cost (or total amount of rent payments expected to be paid by the lessee under the term of the lease, including renewal periods) of not more than \$1 million.

Conformity to Book Capitalization of Repair and Maintenance

This election allows a taxpayer to capitalize amounts that are deductible for taxable income purposes, if those amounts are capitalized for financial accounting purposes. This election permits a taxpayer to capitalize for taxable income purposes amounts already capitalized for financial accounting purposes.

NEXT STEPS

Although the Regulations affect many issues related to tangible property, the Regulations do offer flexibility and options for determining the best course of action. Taxpayers should discuss the potential implications of these Regulations with their tax advisor to plan to reap the benefits and avoid potentially adverse consequences.

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ARE SHOPPING CENTERS SAFE? ARE THEY GETTING SAFER?

By Rich Hauer, BDO consultant



Recently, over the course of twenty-four hours, there was constant news coverage regarding the threat of terrorism focused on the Mall of America in Bloomington, Minnesota; a 2.5-million-square-foot, super regional mall with annual visits between 35 and 40 million. Purportedly, Al-Shabaab, the terrorist group responsible for the 2013 attack on the Westgate Mall in Nairobi, Kenya, called for more attacks on shopping centers. The terrorist group specifically singled out the Mall of America, the West Edmonton Mall in Canada and the Oxford Street shopping area in London. However, since this story was exhausted, there seems to be little ongoing discussion about these threats and the security of the consumer. Understandably, the average shopper is concerned about their family's safety and wonders if landlords are taking the necessary precautions to mitigate risk or if the concerns are pushed to the side once the news coverage dies down.

So what is really going on behind the scenes? Are mall owners doing enough to protect their customers?

First, it is important to know that threats on shopping centers is nothing new, and that landlords have been struggling for years with the constantly changing world of security and the cost benefit relationships of various security measures. In 1998, there was an attack in Istanbul, Turkey; in 1999, a bomb was placed in the amusement arcade of the Manzhay mall in Moscow and in 2000, a mall in Cape Town South Africa was attacked. Since 1998, there have been approximately 60 attacks on shopping centers in 21 different countries. By nature, mall owners want their properties to be open and inviting. Therefore, large shopping areas are and will always remain a target.

Due to the increase in attacks and threats against shopping centers throughout the

world, many local and state agencies and groups have pooled together resources to help property owners and local municipalities address this constantly changing and ever-evolving challenge. After September 2011, the International Council for Shopping Centers (ICSC), spent more than \$2 million to develop a training program that was offered free of charge to its members, and the Real Estate Information Sharing and Analysis Center (RE-ISAC) was formed, a public-private partnership between the U.S. real estate industry and Federal homeland security officials.

Additionally, in 2006, the Rand Corporation, a nonprofit research organization, was commissioned to perform a detailed study under the auspices of the Homeland Security Program. The study, "Reducing Terrorism Risk at Shopping Centers," evaluated the effects of incrementally reducing the risk from terrorism by sequentially implementing security options. Model inputs were derived

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from multiple sources, including statistical analyses of historical trends in terrorism, case studies of individual shopping centers and review of security and crime deterrence literature. Ultimately the study provided detail regarding a wide range of deterrents ranging from accurate background checks to the installation of anthrax and chemical detectors and that most risk reduction occurs with the highest priority options and that the principle risk reducing options do not vary much from property to property.

Clearly, landlords, tenants, trade organizations and local and Federal police officials have been addressing these issues for years, long before the most recent threat on the Mall of America. The question is, and has always been, how much security is necessary and what the appropriate mix is. Although the tangible cost of additional security is easy to quantify, it's the intangibles that are hard to evaluate. In some cases, extreme high-priority tactics may scare away shoppers; however, in other scenarios, additional and evident protection and security could drive additional traffic to the property. Mall owners are always trying to build an experience, from branding their properties to adding roller coasters and mini-golf to the common area. The key is the mix, the ability to increase security without ruining the experience.

In the past, security concerns were centered on protecting the public from disturbances created from unruly and disruptive behavior. Traditionally, the increased presence of security guards would act as a deterrent. However, when addressing the more recent risks of terrorism, visible guards can become a target, not a deterrent. Therefore, as the threats change and become more sophisticated, so has the variety of security tactics. Since 2011, mall owners have made structural changes to their properties to help limit the risk of damage and casualties resulting from an attack. Changes have included limiting access to service corridors, adding concrete barriers to prevent against car bombs and placing interior standoffs throughout the mall to protect important structural beams. More important though, may be the implementation of less visible enhancements. According to Kevin Kelly, Securitas USA, one of the largest providers of

mall security, many changes since September 2011 have been "behind the scenes" and focused on proper communication and reporting. For example, landlords used to keep details of a disturbance to themselves, rather than risk bad publicity, especially from a competing landlord. Today, mall owners understand the importance of sharing information, especially when competing properties are in the same area and in the same line of danger. Mr. Kelly continues to explain that there are now strict reporting requirements for the mall owners and that local and state police have regular training meetings with on-site mall security. Another example Mr. Kelly mentioned is that short-term, kiosk tenants go through a very

detailed background and security checks and are now cross referenced with short-term tenants at other malls. Landlords have also increased the quality and sophistication of cameras throughout the property and have set up teams to monitor social media.

There has definitely been added attention and money when it comes to the security of large shopping centers. Some mall owners can spend in excess of \$2 million to enhance security. Unfortunately, shopping centers, like other public and heavily trafficked areas, will always be the subject of terrorist threats. Fortunately, additional resources and an increased focus leads to a safe shopping experience.





THE FUTURE OF OFFICE SPACE

By Reza Khan, Senior Manager, BDO USA, LLP

AS THE NUMBER OF WEB-BASED RETAIL OPERATORS INCREASED, THE PHYSICAL SPACE REQUIRED BY MUSIC, VIDEO AND BOOK RETAILERS WAS GOING TO REDUCE.

This trend is now starting to resonate with office users, who are turning their attention to space requirement and utilization. One may think this is just a fad but that is not necessarily the case; some in the industry believe efficient office space is going to be the norm going forward.

During the recent economic down turn, tenants started looking to downsize their

space, particularly larger firms, and turned their focus to the adoption of policies for sharing non-dedicated offices and implementing technology to support employees' ability to work anytime and anywhere. This also spawned several flexible working arrangements such as working from home a few days a week or working a 40-hour week in four days, etc., which was aimed specifically at space utilization and cost reduction.

Another area of focus was creative office design, which is often associated with technology firms. Office tenants are starting to adopt this view: less "ME" and more "WE" space.

When the global law firm Greenberg Traurig moved its Atlanta office in 2012,

the firm took the opportunity to design flexible space to meet the need for both collaboration and confidential conversations. "Efficiency was a motivating factor in the move because we all want to make more out of less," says Terry Weiss, a partner at Greenberg Traurig in Atlanta.

WHAT IS DRIVING THE CHANGE?

Tenants are being strategic with the use of their space in order to achieve increased collaboration and productivity, which in turn alleviates the pressure on the bottom line.

More than ten years ago, an average of 250 square feet per office employee was the standard. Currently that number has dropped to approximately 195 square feet. While

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some office tenants are hesitating to commit to large leases primarily due to economic uncertainties, the long-term trend is clearly starting moving towards efficient space usage.

Brian J. Parthum, who tracks employment and economic trends for Southeast Michigan Council of Governments (SEMCOG) in Detroit, said his group highlights the point.

"Our own organization recently moved into a smaller space," Parthum said. "Efficient office design has allowed us to rent 7,000 square feet less space, down from 34,000 square feet, and at a lower rate. Additionally, we now have an office that is more attractive to the next generation of staff. The new space takes advantage of natural light, promotes face-to-face contact, and utilizes laptops, wireless technology, and mobile devices to allow for a more flexible work environment."

Firms that have moved to sharing space are seeing much more efficient utilization rates of 80 to 95 percent as compared to historical rates of around 50 percent. Companies no longer need libraries, file rooms and large copy rooms. Workers can benefit from more spacious and attractive break rooms as a result; more "WE" space.

In addition to bolstering the bottom line, the younger staff members ("Millennials") have grown up surrounded by technology and would expect to experience the same in the office. Technology is changing the way everyone performs their tasks and interacts with colleagues; employees can do business in multiple spaces inside and outside their office buildings. Millennials are very interested in collaborative workspace and they expect the highest level of technology and sustainability.

TRANSFORMING THE TRADITIONAL SPACE

Whether it is new construction or renovating a building, landlords have to make spaces more efficient, which would include lots of natural light and amenities such as hospitality areas with WiFi access. Transforming the traditional break room into a "café" environment is very appealing and helps to foster more informal exchange of thoughts/ideas.

Tenants are also asking for on-site fitness centers and cafeterias with healthy food options that provide a holistic approach to the health of their employees, which serves to boost productivity. In addition, tenants appreciate concierge services and amenities such as dry cleaning pick-up and delivery/package services and shoe repair facilities that make life easier for their employees.

Some tenants have even created a Japanese garden in the middle of their space. This area can be used by employees to enjoy a cup of tea and relax for a few minutes or have lunch away from their desk. Happy employees are more productive.

In addition to changing the floor plans, landlords are catering to the socially responsible generation of tenants by creating greener spaces. While the initial thought is green space will cost more, Ron Berkebile, a management and budget analyst for the City of Virginia Beach, noted the following:

"A 20,000-square-foot space in a standard office building that rents for \$18 per square foot has a total annual cost of \$360,000. A more efficient layout in a newer, green building in which the same tenant may occupy only 15,000 square feet but may have a rent of \$20 per square foot for a total annual bill of \$300,000."

"The tenants benefit from being in a green building workspace; employees are happier and rent reductions are achieved. Alternatively, the building owner benefits from premium rates and more tenants."

While all of the above points are appealing, the pendulum can swing the other way:

1. Some tenants are not happy with downsizing office spaces, arguing that employees are less comfortable and tend to get sick more often if they are constantly working in close proximity to their co-workers.
2. Having people working too closely together is bad for morale and productivity. Even though Millennials work in different ways than previous

generations, people still like some peace and quiet in their own space sometimes.

3. In tough economic times, not all employees may want flexible work arrangements. Reversion to "old school" thoughts such as face time in the office may surface especially if there is a potential reduction in force looming.
4. Some firms that deal with sensitive information will still require space where a certain level of privacy can be achieved. Therefore "WE" space may not be ideal.

CONCLUSION

Landlords need to offer better spaces in order to be competitive in the future. Office space needs to be greener, offer natural light, better temperature controls, better ventilation, offer better technology infrastructure and options for more flexible working arrangements that can be easily reconfigured to accommodate a changing work force. With technology aiding the ability to work mobile, the need for huge corner offices and closed-wall work environments will be significantly reduced.

Efficient utilization of space is here to stay and it is an effective long-term cost reduction initiative and puts pressure on firms to think harder about procuring productive and flexible space. This will parallel the move to more sustainable / green space, while providing more flexibility, with some privacy options.

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PERSPECTIVE IN REAL ESTATE

IF 2014 IS ANY INDICATION, THE REAL ESTATE MARKET RECOVERY IS IN FULL SWING—AND PRIVATE EQUITY REAL ESTATE (PERE) INVESTMENT IS BOOMING.

PERE assets under management (AUM) = reached an all-time high last year, driven by increases in real estate valuations and improving conditions for fundraising.

PERE AUM reached \$742 billion in June of 2014, up from \$697 billion at the end of 2013, according to alternative assets data and research firm Preqin. Total AUM has increased 63 percent since 2010, largely due to the growing value of properties already held. In addition, increased investment activity in recent quarters means that fund managers now have large amounts of unallocated capital, or "dry powder," available for new investments. Global PERE dry powder stood at \$175 billion in June 2014, according to Preqin.

Market conditions are ripe for exits, according to HedgeWeek, which reports that some \$138 billion of capital was returned to investors in 2013—double the \$67 billion returned in 2012. The return of previously tied-up capital could aid fundraising further, as investors look to reinvest in real estate funds.

The Blackstone Group, by far the largest PERE investor, was busy selling properties last year. The company is set to make \$2 billion in profit from its \$8.1 billion sale of warehouse

landlord IndCor Properties, according to the Wall Street Journal's real estate blog. Blackstone is also set to sell a portfolio of Equity Office Properties buildings in the San Francisco area—that it was forced to hold onto during the financial crisis—for \$3.5 billion, according to the New York Times Dealbook blog. In October, Hilton Worldwide Holdings, which is majority-owned by Blackstone, agreed to sell the landmark Waldorf-Astoria hotel to a Chinese insurance company for close to \$2 billion, Dealbook reports.

In keeping with its new "core" private equity strategy—longer-term, lower-risk investments, using less leverage and charging lower fees for slightly lower returns (Source: Business Insider, Reuters)—Blackstone launched its first "core-plus" real estate fund earlier this year to focus on high-quality office buildings, apartment towers and shopping malls, as it expands beyond distressed properties. The fund is aiming for net returns of 10 to 12 percent and expects to raise more than \$5 billion in the next year, according to Bloomberg. Core real estate represents the vast majority of the \$29 trillion in global property investments and Blackstone believes it could have up to \$100 billion in core real estate AUM in ten years, Bloomberg reports.

Investors and shareholders are continuing to push private equity firms to diversify their portfolios. Real estate is a sound option attracting significant investor interest now that real estate markets are well into recovery mode. However, not all private equity firms have enjoyed the same success as Blackstone. The Carlyle Group, for example, currently

manages \$13 billion in real estate assets—compared to Blackstone's \$80 billion—and has had trouble with its real estate funds in Europe. Its first fund, Carlyle Europe Partners II, lost 80 percent in value, and the successor fund to that—a \$2.2 billion vehicle—has so far produced annualized returns of 5 percent, Bloomberg Business Week reports.

Our Sixth Annual PERSpective Private Equity, which examines fund managers' outlook on the private equity environment in 2015, found that only 56 percent characterize the markets as either very or somewhat favorable, a decline from the 72 percent expressing positive sentiments in 2014. Yet, this lukewarm sentiment may exclude the real estate sector: Ripe market conditions, increasing valuations and an interest in diversifying portfolios bode well for PERE investors in the coming year.

PERSpective in Real Estate is a feature examining the role of private equity in the real estate market.

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