

REAL ESTATE + CONSTRUCTION WINTER 2017 CONNECTION



- ▶ **FAST TAKES: UNCERTAINTY LINGERS AFTER HISTORIC BREXIT VOTE**
- ▶ **BIG DATA: HOW BIG AN IMPACT FOR REITS?**
- ▶ **2016 YEAR IN REVIEW: TOP TAX ISSUES IMPACTING THE REAL ESTATE INDUSTRY, PART ONE**
- ▶ **GOTTA GET AWAY: TIMESHARES, HOTELS, AND THE SHARING ECONOMY**
- ▶ **PERSPECTIVE IN REAL ESTATE: A FEATURE EXAMINING THE ROLE OF PRIVATE EQUITY IN THE REAL ESTATE SECTOR.**

Fast Takes: Uncertainty Lingers After Historic Brexit Vote

By Anthony La Malfa

Uncertainty was the prevailing sentiment in the months leading up to the Brexit vote, and continues to characterize the ripple effects now being felt across the globe. The quintessential British phrase, “keep calm and carry on,” has become a motto for many sectors, and real estate is no different. A court battle continues over the legality of invoking Article 50 without Parliament’s approval. Once invoked, the clock would start on a minimum of two years’ worth of “leave” negotiations. The U.S. real estate industry is just beginning to feel the initial aftershocks, but a few trends are taking shape.



Business as usual at home, but with caution

Despite rising property values, currency and market volatility are still dark clouds. Landlords are working against slowing sales and rising vacancy rates in office and multifamily units across the United States. As the Brexit negotiations continue, we can expect to see markets worldwide mirroring the hesitation and political pressure the EU and UK will likely experience.

Adding fuel to the fire, conditions in the U.S. commercial real estate debt market indicate the sector may be heading toward a slowdown. Moody’s Investors Service reported that more than 5.9 percent of the \$390 billion in commercial property mortgages that had been packaged into securities were more than 60 days overdue in payments in September. *The Wall Street Journal* asserted that the default rate is a result of borrowers being unable to pay off 10-year loans that were issued before the 2008 financial crisis.

Introducing another layer of uncertainty to the U.S. markets, risk-retention rules will go into effect on Dec. 24 as part of a larger overhaul of the Dodd-Frank Act. These rules will require CMBS issuers (or a third party) to retain a minimum of 5 percent of the securities they create through securitization for 10 years, which could make borrowing a costlier undertaking.

Markets crowd, fueling exploration

Nervousness in the markets, combined with new rules ramping up requirements for security and identification for foreign buyers, has slowed sales in U.S. gateway markets, including New York, Boston and Los Angeles. In particular, high-end condo sales have slowed down in the New York City market. On the other hand, sovereign wealth funds are continuing to eye the U.S.

Prices had already reached high, perhaps even unsustainable, levels prior to the Brexit vote. More owners, landlords and investors are getting crowded out of gateway cities, and scooping up opportunities in secondary markets like Dallas, Austin, Chicago and the Carolinas. This trend usually starts with residential properties, then extends to

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You make critical decisions every day in managing your projects and your people, but do you have the time to control the bigger financial management issues facing your business? Many construction and real estate business owners spend their valuable time working in the business, but few are able to devote significant time and resources to working on the business. At Barfield, Murphy, Shank & Smith, our goal is to provide sound advice by developing solutions for the more complex business management needs of the construction and real estate industries.

We understand that even the slightest of changes in the economy, stock market or interest rates can have big effects on investors and developers. To remain profitable and positioned for growth, companies need a business advisory firm that knows the industry inside and out and can assist in formulating a plan for future success.

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Fast Takes... Continued

other assets as well—currently we're seeing a lot of deals for hotels, healthcare facilities and industrial assets. This situation could change if interest rates rise, as most predict they will in the short term.

Capital could migrate more amid U.S. election aftermath

While the presidential election is still freshly inked, assets could shift in the short term in the wake of President-elect Trump's victory. We could see a dip in

investment from the Middle East, and those investors could be looking to sell existing assets. If that does happen, it will be interesting to see where those funds are re-deployed. Potential targets include major metropolitan and business centers like Hong Kong and Singapore in the Asia-Pacific region.

For general resources on the aftermath of June's "leave" vote, visit BDO UK's [Brexit microsite](#).

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Big Data: How Big An Impact for REITs?

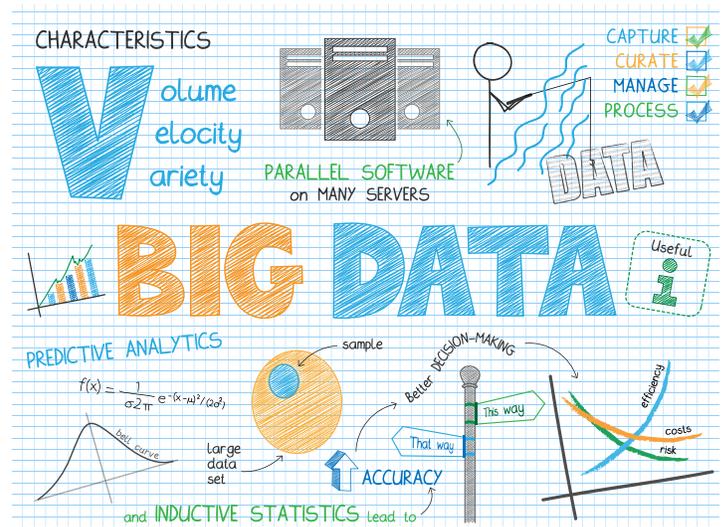
By *Stuart Eisenberg*

Big Data is big-time ubiquitous in headlines across industries, but the real estate industry has been slow to take advantage. That's all changing. Commercial real estate companies and REITs are embracing new technologies to harness the power of Big Data to elevate their investment and management strategies and optimize their operations.

When we talk about Big Data, we mean the exponential growth in volume, variety and velocity of structured and unstructured data. That data, however, is only as useful as our ability to interpret it—an ongoing challenge for every organization. But in recent years, advanced analytics and powerful business intelligence technologies have enabled us to extract real value from Big Data. And it's about time, because Big Data is only getting bigger. Embedded sensor technology and wireless connectivity have opened up a whole new world of information—the so-called "Internet of Things." In real estate, as in most industries, knowledge is power; those who not only have the information but know how to use it are empowered to make smarter decisions, faster.

Of course, all investment decisions ultimately hinge on investors' future predictions. But there are several significant ways real estate developers and owners, REITs included, can gain an edge by turning Big Data into actionable insights.

On the investment front, property owners have access to unprecedented information and intelligence around demographics, supply and demand trends and economic nuances—and better algorithms to analyze that intelligence. At a time when REITs are wise to exercise restraint in their investment decisions and deploy capital sensibly, this could be a valuable tool to help them better understand and target certain markets. At the property level, many variables impact an asset's value, and with the rise of Big Data, REITs are able to analyze demand for specific features within a property,



including amenities, as well as LEED status and energy efficiency. This intelligence can help enhance value by better aligning with tenants' demands.

From a management perspective, greater access to demographic and real-time local trend data can help landlords, including REITs, make decisions at the individual property level. When setting rents, for example, REITs might analyze traditional population data along with new, non-traditional data sources to determine if a certain property is a candidate for a rent increase, or if they'll need to invest in upgrades or other perks to attract and keep tenants. Similarly, activity trackers and smart watches and phones mean more data is available than ever before at the individual level. If data indicates people in a certain population center are walking or biking more instead of driving, REITs might forecast increased demand for properties in their portfolios that are near walkable retail centers, entertainment and other amenities.

Big Data... Continued

From an operational perspective, the application of the Internet of Things within properties themselves allows owners to capture and analyze data from physical objects. Many owners are upgrading their buildings and automating certain decision-making processes to build efficiencies. For example, many have installed smart sensors and devices that can track temperature, air quality and other metrics that proactively alert owners to maintenance or repair needs within their properties. Many are also automating back-office processes. As more new

technologies come into the market, REITs and other property owners will be better able to monitor properties, trim costs and make their overall operations processes smarter.

It's clear that Big Data affords real estate owners and REITs a big dose of opportunity to better predict, monitor and measure their investments, and could ultimately unlock more value for shareholders.

This piece originally ran in Commercial Property Executive.

2016 Year in Review: Top Tax Issues Impacting the Real Estate Industry, Part One

By Tanya Thomas and Jeff Bilsky

The next tax filing season may seem far away, but as 2016 ends, taxpayers will begin the task of year-end tax planning. While 2016 was not a year for major tax reform or legislative action, there have been some notable regulatory changes. 2016 saw several pieces of regulatory guidance that could have an impact on acquisition and disposition transactions, entity structuring activities, taxable income calculations and tax accounting method options. As real estate owners and operators, construction companies, developers and REITs embark on analyzing their tax situation for 2016 and beyond, it's critical to be aware of these new developments.

Though many tax changes proposed or finalized in 2016 could impact the real estate industry, in this article we highlight two areas that should be top of mind for leaders in the real estate industry at the start of the new year, including IRC Sections 704, 707 and 752.

IRC Section 385 Regulations

Debt equity regulations under IRC Section 385 were finalized in October. The proposed regulations, issued in April, were set to re-characterize certain intercompany debt instruments as equity, most likely preferred equity. If finalized as they were proposed, these regulations

could have adversely impacted REITs and caused qualification issues with the REIT testing provisions. The finalized regulations significantly altered parts of the proposed regulations and, in general, give the IRS authority to re-characterize certain intercompany debt instruments as stock. The new IRC Section 385 regulations are intended to curb certain earnings stripping situations often used as domestic and international tax planning strategies. The regulations were specifically directed at curtailing inversion transactions, or those involving the movement of a multinational U.S. group's tax residence outside of the United States.

While the new regulations do not appear to adversely impact SEC-registered REITs and their interaction with Taxable REIT Subsidiary (TRS) entities and subsidiary REITs, there is some impact to Foreign Investment in Real Property Tax Act (FIRPTA) "blocker" structures involving a C corporation owning controlling interests in subsidiary REITs. The final regulations exempt "non-controlled" REITs from all aspects of the regulations. As a result, unless controlled by 80 percent or more of vote or value by an includible member of an expanded group, such as a non-REIT C corporation, a REIT will not be part of a member of an expanded group. Based on this

change, there will not be any requirement of additional documentation or re-characterization of debt for the following:

- ▶ Portfolio diversification: Some REITs are reconsidering their focus on SNFs, and are instead pivoting toward a more diverse mix of properties, including medical office buildings and private pay senior housing properties, which are not reliant on government reimbursements.
- ▶ Divesting properties: Other REITs have chosen to spin off their SNF portfolio entirely so they can focus on properties with greater potential for growth and isolate or divest of their SNF exposure.

However, a non-REIT C corporation and its 80 percent-or-more-owned REIT would be within the scope of the final regulations. Because of the new IRC Section 385 regulations, it is critical for taxpayers with "blocker" REIT structures to analyze the new regulations and consider their potential impact and requirements. For more in-depth details of the regulations and the various provisions, refer to our [comprehensive alert](#) on Section 385 issued in October.

2016 Year in Review... Continued

Final, Temporary and Proposed Regulations under IRC Sections 704, 707 and 752

In October, the U.S. Treasury and the IRS released long-awaited guidance on liability allocations under IRC Section 752, disguised sales under IRC Section 707 and deficit restoration obligations under IRC Section 704. IRC Sections 704, 707 and 752 apply to entities that operate as partnerships, and given that many taxpayers in the real estate industry utilize partnerships in their structures, it is critical to evaluate these new rules. The regulations represent significant changes in partnership taxation and will have a critical impact on planning for partnership formation and restructuring transactions, as well as ongoing operations.

When the IRS proposed these regulations in January 2014, it was widely perceived that the regulations could change whether certain obligations resulted in a partner having economic risk of loss for a partnership liability under IRC Section 752. This, in turn, could impact a partner's ability to deduct losses and receive tax-deferred cash distributions from the partnership. Additionally, the originally proposed disguised sale regulations and clarified certain aspects of existing exceptions. The final regulations take a multifaceted approach and address some of the provisions that were accepted when proposed, while withdrawing and re-proposing some of the aspects that tax advisors were concerned about.

- ▶ Final and temporary regulations under IRC Sections 707 and 752 provide guidance around disguised sales of property to or by a partnership and impact existing regulatory exceptions. The regulations severely limit the effectiveness of the debt-financed distribution exception. This is accomplished by changing the way liabilities must be allocated under IRC Section 752 for purposes of the debt-financed distribution exception. Further, the regulations clarify that the preformation expenditure exception

generally applies on an asset-by-asset basis with limited opportunity to aggregate assets. The regulations also eliminate the ability to apply the preformation expenditure exception to expenditures funded with qualified liabilities.

- ▶ Final and temporary regulations under IRC Section 752 provide rules around when certain obligations are recognized for the purpose of determining whether a liability is a recourse partnership liability. The regulations effectively eliminate a taxpayer's ability to use "bottom-dollar guarantees" to create economic risk of loss. Without economic risk of loss, partners may be allocated fewer partnership liabilities, resulting in a lower overall tax basis. A lower tax basis may limit the ability of the partner to deduct allocated losses. Further, partners with negative tax capital accounts may be required to recognize taxable income to the extent at which they are allocated fewer partnership liabilities.
- ▶ Proposed regulations withdraw and re-propose regulations under IRC Sections 752 and 704. These proposed regulations strengthen anti-abuse rules in determining whether a partner bears economic risk of loss for partnership liabilities under IRC Section 752, and would create similar anti-abuse rules relating to certain obligations to restore a deficit in a partner's capital account under IRC Section 704.

The new regulations are important because real estate taxpayers often operate in a partnership format or use partnerships in their organizational structures. Within the REIT industry, these new provisions could significantly impact the operating partnership under REITs or UPREITs, including the formation of UPREITs.

In October, BDO's National Tax Office issued three alerts related to the new partnership regulations. For an in-depth discussion of these regulations and their

applicability, refer to our [alert](#) addressing disguised sales under IRCS Section 707 and Section 752, our [alert](#) relating to the determination of recourse liabilities under Section 752, and our [alert](#) discussing the re-proposed regulations.

Conclusion

As we barrel toward the start of another year and a new president prepares to take office and potentially institute more significant tax reform, the time to review regulatory tax changes is now. Real estate owners and operators, construction companies, developers and REITs face an array of opportunities and challenges in the new year. With forthcoming uncertainty due to market fluctuations and a potential increase in interest rates, getting into compliance with new tax provisions now could establish a sturdier foundation for real estate companies to weather potential disruptions ahead.

Stay tuned for more of this series in future issues of the *Real Estate & Construction Monitor*, where we'll continue this discussion, focusing on other key tax developments impacting the real estate industry and developments specifically applicable to REITs. In part two, we'll examine several recent court decisions and rulings that could have an impact on the real estate industry with respect to acquisitions and dispositions and tax accounting methods.

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Gotta Get Away: Timeshares, Hotels and the Sharing Economy

By Kevin Riley

It's a familiar tale: An entrepreneurial business model enters the real estate market, disrupting traditional players. Even now-ubiquitous chain hotels were once a disruptor and, in the 1970s, timeshare executives were the ones shaking up the hospitality market. Timeshares became such a competitive presence that every major hotel conglomerate entered the market and acquired existing, successful companies. Now, in the past few years, timeshare businesses have adapted to the digital age and rapidly diversified their offerings to appeal to a changing consumer base. Perhaps because of its entrepreneurial roots, the timeshare industry may be well-positioned to adapt and weather the market's newest disruption: the sharing economy and the growth of online rental platforms offering an alternative—and in many cases, more affordable—hospitality experience.

The power is in the hands of the consumer. With an expanding pool of options available for consumers, vacation rental providers are jockeying for travelers' dollars. Online platforms, such as HomeAway, and its subsidiary VRBO, offer consumers a different travel experience, with accommodations available at their fingertips. The flexibility these platforms provide has particularly resonated with millennials and anyone traveling on a budget.

Because the traditional timeshare model offers an alternative to purchasing a second home, rental platforms have impacted timeshares differently than hotels. Timeshare buyers have long had access to a variety of travel destinations without the hassle of upkeep and maintenance. Destination choices, however, have evolved. For the past 15 years, some timeshare operators have prioritized expanding into urban areas, including major hubs like New York City and Miami, as well as secondary urban markets gaining popularity as cultural destinations, like Boston, San Diego, Vancouver and New Orleans. And competition could get fiercer in those markets, particularly because many customers are swayed by the authentic travel experience online rental platforms can offer via homestays and other non-traditional arrangements.

In addition to providing greater exposure for smaller competitors, the secure automated payment processing capabilities of online rental platforms also removed a barrier to entry into the market for these smaller players. Companies with a modest supply of vacation rentals, for example, may not have had the ability to obtain a merchant account to enable online transactions. While online rental platforms charge a host service fee for each transaction, that fee is a much cheaper alternative to a merchant account and allows small players to offer a convenience on par with larger hotels and timeshare companies.



As a testament to its financial adaptability, the timeshare industry has seen prominent deal activity in 2016. In June, private equity investment firm Apollo Global acquired Diamond Resorts International Inc. Following suit of other major hotel conglomerates, this December, Hilton Worldwide Holdings' board of directors approved the spinoff of its timeshare business, Hilton Grand Vacations, which represented 12 percent of their top line, and Park Hotels & Resorts, Inc. The spinoffs are expected to be finalized in early January 2017. Starwood Hotels and Resorts also completed the spinoff and sale of its timeshare business, Vistana Signature Experiences this year, before finalizing its merger with Marriott, in September. Because the hotel industry is an entirely different business than timeshares, with different multiples and earnings, spinning off timeshares into a separate public entity is a common strategy.

All signs point to sustained growth of the sharing economy in the coming years. Hotel owners and timeshare operators alike would be wise to develop agile service offerings and adaptable marketing strategies to prepare for disruptions on the horizon and secure their share of the market.

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PERSPECTIVE IN REAL ESTATE:

A FEATURE EXAMINING THE ROLE OF PRIVATE EQUITY IN THE REAL ESTATE SECTOR.

Federal regulators—the Federal Deposit Insurance Corporation (FDIC) and the Office of the Comptroller of the Currency (OCC)—have increased their scrutiny of commercial real estate loans, urging lenders to strengthen terms amid fears of a real estate bubble. This is deterring small, local banks from issuing new loans, and many are selling off the loans they do own to PE firms, pension funds, foreign banks and other institutional lenders, according to *The New York Times*. Large banks are also retreating, as they can no longer count on selling portions of large loans to smaller banks.

The absence of other lenders is drawing PE firms, hedge funds and REITs into the debt investing space, with a particular focus on bridge and mezzanine loans. Last year, private equity real estate debt funds raised \$15 billion, with just 5 percent of firms targeting bridge loans. Research firm Preqin predicts fundraising will be stronger this year, with 48 percent of firms targeting mezzanine loans and 23 percent considering bridge loans. Just 5 percent of firms were looking at bridge loans last year.

The last four years have seen a rush of new bridge lenders coming to market, including Calmwater Capital, Streamline Realty Funding, ACORE Capital, Amherst Capital and RealtyMogul, *National Real*

Estate Investor reports. Existing private lenders—Blackstone and Starwood at the high end, as well as smaller lenders, including PrimeLending, Mesa West Capital and Garrison Investment Group—have increased issuance, providing non-recourse transitional or bridge loans.

Pension funds and institutional investors have been increasing allocations to real estate over the past several years, despite geopolitical uncertainty that has reduced confidence in the market. Average target allocation to real estate among global institutional investors will hit 10.3 percent in 2017 totaling more than \$1.07 trillion, up from 9.9 percent in 2016, according to a study from real estate advisory firm Hodes Weill and Cornell University. However, as a defensive strategy ahead of a potential down cycle, these firms are increasingly focused on debt rather than equity, according to *The Telegraph*.

Despite the maturity of the market, capital will continue flowing into the sector in 2017 as institutional investors seek to achieve their return objectives in the continued low-yield environment, *National Real Estate Investor* reports. But class-B properties in secondary cities—which can offer higher yields, but are riskier—are becoming less popular. Instead, many core institutional investors

are exercising more caution and flocking toward more reliable assets in major market areas with credit tenancy and sold leasing in place.

There is a potential for strong exits and fundraising in the current market. PE titan Blackstone sold \$7.2 billion in real estate assets in the third quarter, and raised \$68.5 billion in new funds during the first three quarters, lifting the firm's assets under management to a record-high \$361 billion, *The Wall Street Journal* reported.

As real estate becomes an increasingly mainstream alternative asset class, debt-related funds present a significant opportunity for PE firms and pension funds looking to achieve reliable returns and safeguard against a potential downturn in the real estate market.

Sources: *Bloomberg, Mansion Global, National Real Estate Investor Online, New York Times, The Real Deal, The Telegraph, Wall Street Journal*

FUTURE PERSPECTIVES: WHAT'S NEXT FOR REAL ESTATE INVESTORS?

Trump administration policy details are largely still unknown, but proposed tax cuts and infrastructure spending could be a boon for real estate development as well as the construction industry. However, if the tax rate on carried interest is increased, as President-elect Trump has previously advocated, it could dampen PE real estate deal flow, according to *Bloomberg*. On the other hand, a separate and contradictory proposal could reduce the tax burden for hedge fund, VC and PE fund managers dramatically, having the opposite effect. Meanwhile, protectionist policies could hurt international investment. Cross-border spending reached \$100 billion in 2015—18 percent of total U.S. commercial real estate spending, *Bloomberg* reports. For the near future, uncertainty is the only certainty, and fund managers may seek to diversify their holdings, to the benefit of secondary markets like Melbourne, Amsterdam and Vancouver, according to *Mansion Global*.



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DID YOU KNOW?

According to a RCA report, transaction volume for commercial properties through October 2016 totaled \$384.4 billion, down 12 percent compared to the same period in 2015.

In the first half of 2016, Chinese investors bought an estimated \$15 billion worth of overseas real estate, which nearly matches the amount invested in 2015.

According to an estimate released by the Bureau of Economic Analysis this November, real U.S. GDP

increased by an annualized 3.2 percent in Q3 of 2016.

Commercial property sales volume totaled \$345.5 billion in the first nine months of 2016, down 8.6 percent, according to Real Capital Analytics.

According to the Bureau of Labor Statistics, the construction industry added 11,000 jobs in October, reaching the highest total construction employment since December 2008.

Construction on new houses

increased nearly 26 percent in October, reaching the highest level in nine years, according to the U.S. Census Bureau.

According to the National Association of Real Estate Investment Trusts, Equity REITs had a debt ratio of 31 percent as of Q2 2016.



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