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U.S. REITs:**An Overview***By Anthony La Malfa, CPA*

The culmination of five years of steadily rising prices for U.S. REIT shares reached a climax of sorts in November with the purchase of Equity Office Properties (EOP) for \$36 billion, by the Blackstone Group, a private equity fund. Blackstone had previously purchased two other office REITs—Trizec Properties Inc. and Carr-America. The series of purchases clearly indicates Blackstone's belief that the recovery in the office building market has some way to go and that the U.S. economy continues to be in an expansion phase.

The trend toward "privatization" of public REITs reflects the underlying assumption that public real estate, notwithstanding the strong price gains in recent years, is undervalued in comparison with private ownership. There are several possible reasons for this. One reason is that publicly-owned REITs normally limit the percentage of debt to 40-plus percent in order to reduce the possibility of significant price declines if interest rates rise—a situation that caused a significant REIT price decline in the mid-1990s. Private owners, on the other hand, often utilize a much higher debt-to-equity ratio in order to increase returns, accepting the risk of higher interest rates.

A second reason why REITs are attractive to private buyers is that private firms are not under pressure to pay high dividends as are public REITs, thus making cash available for additional acquisitions. Finally, firms acquiring public REITs may be anticipating selling off properties at a fairly early date in the future if prices continue to rise.

Overall Outlook

In its October 2006 industry study of U.S. REITs, Moody's Investors Service said it maintains a stable rating outlook on 92 percent of the companies, with only

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2 percent having a negative rating and six percent subject to review for downgrades. Overall, the firms are viewed as being prudently managed, with leverage and secured debt levels flat to up modestly and with increasing fixed charge coverage and operating margins.

Separately, Prudential Real Estate Investors (PREI), in its third quarter 2006 Market Perspective, says it expects the Property Index of the National Council of Real Estate Investment Funds (NCREIF) to show a total return in the 15 percent range. Next year, total return is projected to be between 12 and 15 percent, subject however to two conditions: no sudden weakness in the economy and interest rates remaining close to the 4.5 – 5.25 percent range existing in 2006.

Apartment Sector

The apartment sector in 2006 enjoyed its most successful year since 2000 and according to some commentators now offers good investment opportunities. A key reason is that land and construction costs remain at high levels, making new development unattractive. As a result, apartment REITs are able to maintain solid cash flows and high dividend payments. In many cases, apartment occupancies are 95 percent or above, giving landlords pricing power and virtually eliminating the need for any concessions.

One shadow on the horizon is the weakness in condominium markets due to overbuilding, with sales plummeting in some key cities. This is likely to result in buildings converted to rental use, possibly creating an oversupply of apartments in some markets. Over the longer term, however, prospects for the apartment sector seem strong since the two major groups who favor apartments—the 19-25 age group and

new immigrants to the U.S.—are increasing in numbers.

One caveat for apartment investors at this time is the narrow spread between primary and secondary markets and between Class A, B and C properties. If and when demand for apartments declines, the spreads among these apartment types is likely to widen, meaning lower prices for the less desirable B and C properties.

Retail Sector

Retail properties have been very stable over the past few years as rents have continued to grow. Nevertheless, investor demand has been diminishing for the past several quarters as investors have concentrated on other property types that have been seeing more rapid growth. As a result, retail has been the only property type where sales in most of 2006 have declined from last year. The result is that some attractive buying opportunities may arise for long-term investors. The best opportunities should be in markets where residential development has been expanding rapidly and where retail supply has not kept pace. The rating outlook of Moody's Investors Service for retail REITs remains stable, a reflection of continued consumer spending. The risk levels are highest for B and C regional malls and for community centers with weak grocery and/or discount anchors; and anchor sites that are too small.

Major trends in the retail sector include consolidation of REITs and retailers, retail expansion, property redevelopment and international expansion. Consolidation of ownership can be positive if it creates a more geographically and tenant diverse company. However, consolidation can increase risk if it is debt financed.

Several new trends can provide additional support for retail valuations. These include the use of new concepts in sales as well as new companies to fill niches or to market to specific age groups. These often result in meta-credit ratings as they utilize space vacated by anchor consolidation and tenant downsizing.

Office Sector

Capital continues to flow to the office sector, reflecting an ongoing recovery and strong market fundamentals. In the third quarter of 2006, indications were that the average vacancy rate in a 56-market universe declined to just under 13 percent, the lowest level since 2001. In downtown markets, vacancy rates declined to just under 11 percent, while in suburban markets, vacancies averaged about 14 percent.

The improvement in the office sector essentially reflects job growth. While growth in 2006 has been slower than expected, year-over-year growth has been much healthier than might appear. On the positive side, sharply higher construction costs discourage new supply. However, if employment does not continue to increase, further improvement in the office sector is not likely. While Moody's rating outlook for office REITs is stable, it expects employment growth to slow over the next few years, which should slow the pace of improvement over many markets.

Industrial Sector

Moody's rating outlook for industrial REITs is stable, reflecting improving economic fundamentals and operating performance. The industrial property cycle appears to be on an upswing because the manufacturing economy is expanding. Manufacturing output is a key leading indication of absorption in the

industrial property markets, and this should lead to some measure of pricing power for industrial property rents in the next year or two. Another positive feature for the sector is the growing reliance by industrial REITs on fees and gains generated through joint ventures and real estate fund structures as well international investments.

Anthony La Malfa is a manager in the Real Estate & Hospitality Services Group in the New York Office of BDO Seidman, LLP. He can be reached at (212) 885-8140.

Development: Joint Ventures With Investors

By Brian Bader, CPA

As more and more capital flows into real estate, financing structures are becoming more sophisticated, slicing the two Rs--risk and return--in a wide variety of ways. This often is the case in development financing, where potential profits are high but risks are too. The goal of these arrangements is to assure the investment group some type of priority return, plus a participation in the ultimate profits, while at the same time giving the developer the necessary incentive to proceed with the project. The investment can be pure equity or part loan and part equity. The following are some key elements to be negotiated in setting up this type of transaction.

Return of Capital and Preferred Return

The initial negotiating issue is the amount of capital the investor will put in the project and the preferred return to be received. Assume the investment group puts up 30 percent of the equity. In a "pari passu" structure, assuming the project is successful, both investor and developer will share the proceeds until they receive back their capital in-

vestment and a specified return (say, 10 percent). By comparison, in a subordinated arrangement, either or both the investor's return of capital and preferred return will have priority over that of the developer.

Look-back Return

In a further variation of the investor's priority position, he may be given a "look-back return." This assures him that he will receive the promised return before the developer shares in the remaining cash flow.

Example: Assume the partners agree that cash flow will be distributed in the following order: (1) return of capital to the investor followed by return of capital to the developer; (2) preferred 10 percent return to the investor followed by a similar return to the developer. Assume further that the initial projection was that a 15 percent return would be realized. If the investor has a look-back return, he then receives an additional 5 percent of cash flow so that his total return equals 15 percent. After that, the developer either may receive a similar return or the remaining cash flow will be divided on an agreed-upon basis, for example, 50-50. The look-back return has the purpose of giving the developer the maximum incentive to meet the construction schedule and manage the property efficiently because most of his return will not be paid unless the project is very successful or can be sold at a significant profit.

The Promote and Tiered Rates of Return

The previous example involved priority and subordinated distributions. A further variation involves increasing in the share of the developer as higher rates of return are realized. The joint venture agreement may provide that the investor

receives 80 percent and the developer 20 percent of the cash flow up to the point where the investor realizes, say, a 15 percent return. After that, the developer's share may be "promoted" to 30 percent and the investor's share reduced to 70 percent. If the investor's return subsequently reaches 20 percent, the developer's promote may be further increased so that the split becomes 60-40 or even 50-50. Similarly to the above, this gives the developer the incentive to use his best efforts.

Pooling Deals and the Clawbacks

An institution such as a pension fund, once having chosen an operating partner, hopes to do more than one transaction. If each deal is completely separate from the others, the operating partner (whose profit generally is back-ended as described above) may be tempted to take excessive risks because losses will be borne primarily by the institution while the operating partner will benefit more on a very successful deal. To prevent this from happening, many institutions insist that all deals with a single operating partner be pooled and be subject to a "clawback", i.e., the right of the institution to use some of the operating partner's profits in one deal to reduce the capital partner's losses on a subsequent deal.

Brian Bader is a Partner in the Real Estate and Hospitality Services practice in BDO Seidman's New York office. He can be reached at (212) 885-8203.

Population: The Future of the United States

By Dan DTtieri, CPA

Having recently reached the 300 million mark, the U.S. population will grow by an additional 100 million in the next 40 years, according to a

lengthy report by the Center for Environment and Population, a non-profit research, policy and public advocacy organization based in New Canaan, Connecticut.

The detailed study contains a vast amount of information about where people will live, composition of households and the environmental challenges that will arise with respect to land and water use, forests, agriculture, energy and climate change.

Where We Live

The U.S. is the third most populous country in the world after China and India, but represents only five percent of the global population. A total of 80 percent of Americans live in urban areas. The South and West now contain over half the entire U.S. population. The Northeast remains the most densely populated region.

Over half of all Americans live within 50 miles of the coast, living in only 17 percent of our land area. Put in other terms, population density on the coasts is five times that of other parts of the country. Of the nation's ten fastest growing states, half are in the coastal south and another four are in the driest western areas, making them among the nation's most vulnerable "population/environment" hotspots.

Population Growth

Of the expected increase of 100 million persons in the next 40 years, 60 million are likely to represent natural increase (births minus deaths) while 40 million will be due to immigration. About one million legal immigrants come here each year, while the unauthorized immigrant population is estimated to be about 525,000 annually. The report says that about one-third of all immigrants later return to their home countries.

Population Distribution

The South and West are the fastest growing regions in the nation. A total of 57 percent currently live in the South and West following 15 years in which those two regions grew twice as fast as the Northeast and Midwest. In the coming decades, most growth is expected to occur in the South (52 percent) and West (35 percent) with much slower growth in the Midwest (7 percent) and Northeast (5 percent).

Population Composition

The makeup of a population—age, income, education, culture and race—determine where and how people live and develop land. Today, the 1-24 age group is about 35 percent of the total, while the 24-44 age group is 30 percent. Since these are the child-bearing ages, the momentum for future population growth already is in place.

At the same time, because of our overall population growth, older Americans are more numerous than ever before. Aging Baby Boomers (born between 1946 and 1964) constitute 78 million people, 20 percent of our total population. They are wealthier and consume more resources than any previous generation. The generation ahead of them (60 and over) is increasingly moving to the retirement states of Arizona, Florida and Nevada, where pressure on natural resources, especially water, already is evident.

Household Growth

In recent years, the average U.S. household size has gone down (from 3.1 persons in 1970 to 2.6 persons in 2000). At the same time, the number of households has multiplied, now approximately 110 million. (In 1900, the number was about 20 million.)

While household size is decreasing, the average size of new single-

family homes rose by more than 700 square feet in recent years. The combination of smaller household size and population growth is one important cause of the nationwide building boom since 1990, when 14 million new housing units were built. The State of Nevada saw a 60 percent increase in housing units between 1990 and 2000, far outstripping every other state.

Dan DiTieri is a director in the Real Estate Practice Group in the New York office of BDO Seidman, LLP. He can be reached at (212) 885-8378.

Development: Qualifying for Capital Gain

by Eric Kea and David Patch

The gain recognized by real estate developers upon sale of developed land is generally ordinary income because land held "primarily for sale to customers in the ordinary course of a trade or business" does not qualify as a capital asset. However, if land is held in an entity such as a partnership or S corporation, it is the business and intent of the entity itself and not the partners or shareholders that is determinative. Thus an entity owned by a real estate developer can obtain capital gain on the sale of land if it is not itself engaged in a real estate development business.

Achieving Capital Gain

To take advantage of the planning opportunity, real estate developers should acquire land they may want to develop in an investment entity. Activities that enhance the property's value, such as rezoning efforts, engineering studies and preliminary platting can be pursued by the entity without tainting the character of the land so long as the activities do not rise to the level of a trade or business. If and when the land is ready for development, it

can be sold to a development entity with gain from the sale qualifying as capital gain.

Caution: An important point to remember is that the investment entity and the development entity cannot be the same type. If one is a partnership, the other must be an S corporation or other form of ownership.

Varying degrees of related ownership between the investment and development entities are permissible, depending on the circumstances, but courts have respected up to 100 percent common ownership in some cases. The end result is that developers who would have recognized ordinary income on the development and sale of land obtain capital gain treatment on pre-development appreciation.

Timing is Important

This strategy is best implemented before acquisition, but in any case must be prior to significant development activity with respect to the subject property. Advance planning is often necessary, and the participation of a tax professional with knowledge of the relevant issues is highly recommended.

Eric Kea is a Partner and the Chairman of the National Passthrough Entity Tax Consulting Group at BDO Seidman, LLP. He can be reached at (212) 885-8101. David Patch is Senior Manager in BDO Seidman's National Tax Office and is a member of the National Passthrough Entity Tax Group. He can be reached at (301) 634-4965.

Fraud: Sale of Interests to General Partners

By Alvin Arnold

A federal district court ruled that investors in a Section 8 project can pursue securities fraud claims against the general partners for inducing them to sell their interests without disclosing the prospects

for increased returns through sale, refinancing, or participation in the mark-up-to-market program. (*Gerber v. Bowditch*, 2006 WL 1284232) (D. Mass.).

Background

The plaintiffs were investor limited partners in Old Salem Associates Limited Partnership, the owner of a 321-unit apartment project with Section 8 contracts for 220 units. Defendants Robert S. Bowditch and Gerald Slavet were the general partners, and defendant Steven Rioff was the Class A limited partner.

In a September 30, 2004 letter, the general partners offered to purchase the limited partners' interests for \$50,000 a unit, about half the initial capital contribution. The tender offer was good for 30 days.

While disclaiming any representation as to the fairness of the offer, the letter said the limited partners were unlikely to recoup their investment through a sale or refinancing. The letter also noted that the Section 8 contracts would expire on March 31, 2005, and although the general partners would request a renewal, "it is not known what rent level HUD will approve at this time."

Tender Offer Accepted

The plaintiffs tendered their interests. After the transaction was completed, they learned the project was eligible for the mark-up-to-market program. The defendants submitted a mark-up-to-market application on November 10, 2004, and HUD approved it on April 5, 2005. The plaintiffs alleged the project thereby stood to realize about \$621,000 in additional annual rent.

According to the plaintiffs, they also received information that MassHousing was willing to refinance the partnership's debt for about \$15 million and that AHP

Holdings Company LLC offered to purchase the partnership assets for about \$14.5 million.

Based upon these allegations, the plaintiffs asserted a number of causes of action, including securities fraud in violation of Section 10(b) of the Securities and Exchange Act and Securities and Exchange Commission (SEC) Rule 10b-5. The defendants moved to dismiss the claims.

Elements of Claim

To state a claim under Rule 10b-5, the court explained, a plaintiff must allege the following elements with particularity: a material misstatement or omission, intent to deceive or defraud; connection with a sale of a security; reliance; causation; and economic loss. In this case, the court said, the plaintiffs satisfied the pleading requirements for the last four elements; so it addressed the first two.

Material Misstatement or Omission

With respect to the first element, the plaintiffs argued that the September 30 letter was material and misleading because it failed to disclose the prospects for increased rental income through the mark-up-to-market program and misrepresented the project's market value.

The defendants contended that the plaintiffs did not meet the pleading standards because they did not explain why the September 30 letter was misleading. The defendants said the statement about the possible MassHousing refinancing was hearsay, that the AHP purchase offer was illusory because it lacked detail, and that the potential Section 8 rent increases were too uncertain to guarantee a return on plaintiffs' investment.

Rejecting the defendants' arguments, the court ruled that the

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plaintiffs had met the requirement for pleading material misstatements and omissions, though it noted they must provide additional evidence to prove their case.

Alvin Arnold is the editor of the Monitor. He can be reached at (212) 885-8235.

Commercial Real Estate: Bubble Not Likely

A report by Global Real Analytics (GRA) offers a new perspective on fears that the price increases of the past three years is leading to a "bubble" similar to the one in the late 1980s. Said Richard Wollach, CEO of Global Real Analytics, "Using a base year of 1985, prices are not overblown by historical standards. ... For three or more major property categories, inflation-adjusted values were below those in 1985 and even lower when compared to the peak year for each asset type in the late 1980s real estate bubble."

Specifically, CBD office properties are currently 10.8 percent below 1985 levels (and 14.1 percent below their peak price of 1987). Warehouse properties show a decline of 3.5 percent since 1985 (7.0 percent from the 1988 peak). Retail is down 5.1 percent from 1995 (9.0 percent from the 1987 peak). Only apartments gained in real terms over the past two decades, with an inflation-adjusted appreciation of 43.6 percent.

Positive Features

For several reasons, prices could surpass the previous highs, says Wollach. First, the much greater degree of transparency and discipline in the capital markets has so far prevented unchecked new construction. Second, debt is cheaper, making investments more rational even at current low cap rates. And because of the amount of capital seeking investment, illiquidity risk is lower than in the past. Fourth, commercial

rents have been rising across the board at more than five percent annually since early 2005, offering the best evidence of lack of supply, which could mean higher rent increases and rising net operating income over the next year or two.

Global Perspective

Finally, U.S. commercial real estate prices are lower than those in many foreign nations, one reason why so much foreign capital is coming here. According to Daniel O'Connor, GRA's Managing Director of Global Forecasting, office properties may fetch \$600 to \$700 or higher per square foot in leading office centers around the world. In the West End of London, office prices reached \$1,601 per square foot, compared to \$552 in midtown Manhattan and \$474 in Washington, D.C.

What About Apartments?

In contrast to the other sectors, apartment prices are at record highs, having appreciated by just under 44 percent since 1985. The GRA report suggests several reasons why this does not suggest a bubble in the near future. One reason is that apartments in the 1980s were considered less desirable than other sectors, with a result that apartments were undervalued. Only since the 1990s has this sector been recognized for its investment potential, with a result that much public and private capital has been flowing into that sector.

A second reason why apartment prices are so high is evidence that inventories have not kept up with the growth of U.S. population. While the population has grown by 25 percent since 1985, apartment completions in 2005 were only 60 percent of those in 1985. In addition, much greater mobility in the labor market and continuing high levels of immigration stimulate the demand

for rental apartments. Finally, the two largest population groups—aging baby boomers and 18-34 year olds—are key sources of demand for apartments.

Global Real Analytics LLC provides information to real estate investors and investment managers. For more information, contact Paul Wildes, Director of Marketing and Client Relations, at 415-733-5351 or e-mail to pwildes@global.com.

Material discussed is meant to provide general information and should not be acted upon without first obtaining professional advice appropriately tailored to your individual circumstances.