

# Real Estate Monitor

**Real Estate Investment Funds:**

Understanding Selected  
Terminology .....1

**Investments:**

Break-Even Ratios and  
Sensitivity Analysis .....3

**Leases:**

Hidden Issues in Market Rate  
Renewal Options .....3

**Mortgage Securities:**

Inside the Rating Process .....4

**Year-End Tax Review:**

Rentals, Real Estate Sales  
and Gifts .....5

**Financing:**

Lender Liability for Improper  
Disclosure .....6

**Real Estate Investment Funds:**

## Understanding Selected Terminology

*by John Tax*

Real estate investment agreements often contain specialized terminology likely to be unfamiliar to first-time investors. Some selected key terms are described below.

### The Promote

Investors putting up cash for a real estate project want to receive back their initial investment as soon as possible as well as share in the profits as they are realized. On the other hand, the fund sponsor wants to keep a substantial portion of the profits and also receive back the costs of the project or acquisition as soon as possible. This can be accomplished by a distribution formula divided into two parts.

Until the fund reaches a specified level of return, the outside investors and the sponsor receive distributions in proportion to their share of the invested capital. This formula favors the investors, who may have put up most of the capital (often 98 percent or in some instances 100 percent of the capital). Once distributions reach the specified level of return (the "hurdle"), the sponsor then receives a disproportionately larger share of any additional distributions (called the "promoted interest" or "carried interest").

For example, when the specified return is reached, the sponsor might receive 20 percent of any further distributions even though the sponsor might have invested only 2 percent of the capital. This assures the outside investors that they will receive most or all of their investment initially, while giving the sponsor the incentive to carry through the investment successfully.

### Subsequent Distributions

The next question is how the remaining 80 percent of distributions is to be divided. If the 20 percent received by the sponsor includes both the return on the sponsor's invested capital as well as the "promote," then the remaining 80 percent should be distributed entirely to the outside investors. On the other

hand, if the 20 percent is the “promote” only, the sponsor should also share in the remaining 80 percent in accordance with his percentage of the invested capital. The first approach is relatively common in real estate joint ventures, while the second is more common in commingled funds.

### Clawbacks

A clawback obligation is the promise of the sponsor or general partner that, over the life of the fund, the sponsor will not receive a larger share of distributions than originally bargained. Generally, this means that the sponsor can not keep distributions representing more than a specified percentage (e.g., 20 percent) of the fund's cumulative profits. When triggered, the clawback requires the sponsor return to the fund's investors an amount equal to that determined to be “excess” distributions (should the fund not meet its stated or expected goals).

Most venture funds operate on a “net” basis, under which portfolio gains and losses are measured on a cumulative basis over the entire life of the fund. If the investment agreement permits the sponsor to receive early distributions of gains that may prove excessive when matched against later portfolio losses, then the earlier “carried interest” payments can prove to have been excessive. This may trigger a clawback.

### Subsequent Investors

It is often the case that a real estate fund will admit partners over a period of time rather than all at once. If the fund already has begun to make investments when new investors are added, the new investors must “buy in” to the existing investments. This can be

done by distributing the new capital among the existing investors so that after the contribution, all investors will have investments in proportion to their percentage interests in the fund. In addition, new investors typically will pay a “cost of carry” to the existing investors. This often is equal to the minimum preferred return. More recently, new investors now often are charged a premium above the minimum preferred return. This is justified by saying that the underlying assets are likely to have appreciated beyond the minimum preferred return.

### The Hurdle Rate

The hurdle rate represents the minimum rate of return—the threshold rate—that an investor expects to receive. The three elements of a return on investment (ROI) are the time value of money, the projected inflation rate, and the risk of loss to the investor. In addition, an investor reading a “pro forma” cash flow statement for a proposed investment must be careful to ascertain whether the statement reflects the cost of debt, which has first claim on the cash flow from the property.

### Cost of Debt

Real estate investments traditionally are funded by a high percentage of debt, usually ranging between 65 percent and 85 percent of the appraised value of the real estate. Development projects, which carry the most risk, generally have lower loan-to-value (LTV) ratios, while seasoned properties have higher LTVs. In either case, the investment at a minimum must provide a return sufficient to pay the debt service (including loan amortization).

In the case of a standing (no amortization) or balloon loan, the investors normally assume that the loan can be refinanced at maturity.

However, this adds an additional element of risk to the transaction. It is generally accepted that the interest rate for commercial real estate loans should be similar to the return on BBB-rated (medium grade) corporate debt, although in the case of higher-quality properties, the comparison can be to A-rated debt.

### Cost of Equity

Much more problematic is the cost of the equity portion of the capital structure (i.e., the return required by the investors). When no priorities exist among the equity investors, the cost of equity is the hurdle rate for all. When priorities do exist, as when certain investors have prior claims to the cash flow after debt service, each group establishes its own hurdle rate. In either case, the hurdle rate is based on both the cash flow from the property and its expected appreciation in value over the holding period (often assumed to be ten years or less for so-called “opportunistic funds”).

### Bond-Premium Model

While some investors establish an arbitrary hurdle rate, this fails to reflect different types of property, different inflation rates and holding periods. A more satisfactory approach is the bond-premium model, according to which an investor should receive a return equivalent to the cost of debt plus an additional premium for risk. The equity premium generally is considered to range between 4 and 8 percent above the effective cost of debt and after taxes.

*John Tax is a Director in the Real Estate and Hospitality practice in BDO Seidman's New York office. He can be reached at (212) 885-8027.*

## Investments: Break-Even Ratios and Sensitivity Analysis

By Brian Bader, CPA

With concern being expressed that the real estate cycle is peaking due to overpriced properties and the possibility of a recession, real estate buyers, in the classic phrase, should use a sharp pencil when analyzing a proposed investment. Two analytical tools for doing so are the break-even ratio and sensitivity analysis.

### Break-Even Ratio

The break-even ratio (also known as the default ratio) shows the relationship between: (1) operating expenses and debt service; and (2) effective rental income (scheduled rent minus an assumed vacancy rate).

First and foremost, the break-even level shows the minimum rent that must be paid each month in order to cover all costs. An apartment building with a typical mortgage, for example, may have a break-even ratio of 82 percent, i.e., 82 cents of each rental dollar must be used to cover operating costs and loan payments. The remaining 18 cents is the return on the owner's equity (before considering any tax benefits from depreciation deductions and the equity buildup from loan amortization).

From a lender's point of view, the break-even ratio is the default ratio, i.e., the point after which the borrower may be forced to default on the loan, reach into his or her own pocket to make up a deficit, or engage in risky management practices such as deferred maintenance.

### Exhibit 1

#### Effect of Occupancy Changes on Income and Return on Equity (ROE)

Occupancy Rate	Gross Rents	Cash Flow	ROE
99%	\$267,300	\$49,300	12.3%
97%	\$261,900	\$43,900	11.0%
95%	\$256,500	\$38,500	9.6%
93%	\$251,100	\$33,100	8.3%
91%	\$245,700	\$27,700	6.9%

### Sensitivity Analysis: One Component

Once having determined the break-even ratio on the basis either of existing or projected figures, the investor can take a further step. This is to determine how sensitive the ratio is to changes in any key component—rent income; operating expenses (or any separate item of expense); or debt service (resulting from a change in the interest rate or the debt service on the mortgage). A simple example of sensitivity analysis—when only one component is changed with the others unchanged—illustrates how useful it can be in quantifying an investor's concerns about what may happen in the future.

Assume an investor is considering the purchase of an apartment house of 100 units, requiring \$400,000 cash over the mortgage. Current occupancy is 99 percent at an average apartment rental of \$225 per month (\$2,700 per year). Thus, gross rent is \$267,300 (99 units x \$2,700).

Annual operating expenses are \$100,000 and debt service is expected to be \$118,000. The break-even ratio is 82 percent (\$218,000 divided by \$267,300). The cash flow of \$49,300 would yield 12.3 percent on the equity of \$400,000.

The investor's primary concern is that vacancies may rise if some of

the many new condominiums in the neighborhood are forced to convert to rentals, thus increasing the supply. The investor wishes to test the sensitivity of the projected cash flow to higher vacancies assuming rent levels are unchanged. Exhibit 1 shows the result. If the occupancy rate drops to 91 percent, the break-even ratio rises to 89 percent (\$218,000 operating expenses plus debt service divided by \$245,700). The investor still is earning 6.9 percent on his capital, but the lender may begin to worry, since the original cash flow cushion of \$49,300 has dropped almost in half to \$27,700.

*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.*

## Leases: Hidden Issues in Market Rate Renewal Options

By David Tevlin

A renewal option in a commercial lease often is freely granted to the tenant by the landlord even though the option is one-sided—it will be exercised only if it is beneficial to the tenant. Even when the option is given in exchange for some concession by the tenant, the landlord

should be diligent in drafting language to ensure that the renewal rental will match as closely as possible the fair rental value of the premises at the time the new lease term begins.

Fixing a rent in advance or tying the rent to an outside standard such as the consumer price index has obvious risks for both landlord and tenant. Thus a common provision is that the renewal rental will be based on the "market rate" at the time of renewal, with the issue to be settled by arbitrators in the event the parties themselves cannot agree. However, a market rate option has a number of hidden issues that can make negotiations or arbitration an expensive and frustrating one for the parties.

### Examples of Hidden Issues

The hidden issues in a market rate renewal option generally involve the context in which the "market rent" is to be determined. For example, is the rent to be affected by the tenant's specific use of the premises or by the highest and best use of the premises? If the former is the case rather than the latter, the renewal rent may well be lower than that anticipated by the landlord. A specific reference in the option clause will avoid disputes on this issue.

A tenant may argue that market rent is to be determined by comparison to market rent for renewal leases only and not include new leases. Renewal rents could be lower than initial rents for several reasons, such as: (1) no portion of the rent need be applied to amortize tenant improvements paid for by the landlord; (2) no brokerage commissions need be payable; and (3) no "turnover" period occurs during which no rent is payable. In effect, the tenant is arguing that

market rent should be the equivalent of "net effective" rent to the landlord.

The parties may differ as to whether size is to be considered in choosing space comparable to the premises in question. A tenant leasing small space may argue that it is entitled to the same square foot rental paid by a much larger tenant.

### Ground Leases

When the option to renew applies to a long-term ground lease, the issues become very complex. One particular issue that has given rise to litigation is whether the ground rent is to be determined on the basis of the highest and best use of the land as vacant or as improved with the present structure. This involves assumptions not only about the highest and best use to which the property may be put many years in the future, but also whether new zoning laws will change the permitted use of the property.

### Alternative Right to Negotiate

So long as the landlord and tenant negotiate in good faith, each can hold to their respective positions on the various issues discussed. However, a renewal option typically will provide for arbitration if the parties cannot agree, and the arbitrators' resolution of these issues inevitably will differ from one of the parties. This may be unsatisfactory to the landlord as well as the tenant.

A possible alternative to the renewal option is to include in the lease a "first right to negotiate." This assures the tenant that the landlord will not lease the premises to a third party before negotiating with the tenant. While the tenant cannot be absolutely assured of continued occupancy, the obligation to conduct negotiations in good faith offers some protection. Provisions

of this type usually include dates by which the parties must begin negotiations and when the landlord will be free to negotiate with others.

*David Tevlin is Managing Director, Corporate Real Estate Services, in BDO Seidman's New York office. The lease audit consulting group represents large space users throughout the United States in operating expense and electric energy audits. David can be reached at 212 885-8457.*

## Mortgage Securities: Inside the Rating Process

By Anthony La Malfa

One question being asked about the rating agencies is why they were so late in downgrading CMBS and CRE issues that subsequently experienced problems. A recent report by Moody's Investors Service offers one explanation. Ratings to some extent reflect anticipated future market changes (rising or falling) that would affect a current offering. Several examples of this are as follows:

*Differentiation in property markets:* Differentiation among the different property markets is more prevalent when an economy slips into a downturn because employment and space demand will then differentiate among property types.

*Differentiation in leverage:* Loans with loan-to-value ratios (LTVs) of 70 percent, 80 percent or 90 percent tend to perform about the same in a rising market, but in a falling market, the differences among them will increase.

*Differentiation in losses:* Losses on defaulted loans can be expected to be less in a rising market than in a falling market. Moody's offers the example of a defaulted loan heading toward liquidation with an expected 40 percent loss severity that might see the default drop to 30 percent if prices appreciate by 10 percent during the liquidation period, but

by the same token rise to 50 percent if prices fall by 10 percent.

Loan structure matters: Whereas in a rising market, differences in loan terms may make little difference in performance, the case is different in a declining market where loans with higher amortization rates and more reserves will experience lower loss on default than will other loans.

### Upgrades Outpace Downgrades

During the third quarter of 2007, Moody's rated 148 securitizations that consisted of 1,424 CMBS classes. Of these, 1,075 were affirmations and confirmations, while upgrades numbered 331 and downgrades were only 18. For investment-grade rated classes, upgrades exceeded downgrades by 310 to 7. Roughly 75 percent of all classes remained unchanged.

### Impact on Holders

While the delayed downgrades by the rating agencies can be explained in part (as noted above), the consequences for firms with large holdings of CDOs and related instruments were nothing short of disastrous. This was due to their need to "mark to model" rather than to "market" (because markets were virtually nonexistent).

According to newspaper reports, major firms felt relatively secure in their holdings because they held the "super-senior" tranches of CDOs normally considered almost riskless because the lower tranches are expected to fully absorb any anticipated losses. But since the senior classes needed to be marked to model in order to be valued, the holders were forced to recognize very large "paper" losses when the ratings were slashed.

Quoted in the *New York Times*, Darell Duffie, a finance professor at Stanford University's business school, said "In general, the industry standard model for pricing CDOs is not adequate in my view, which means that there's a lot of uncertainty about what they are worth . . . They can get better models, but that's not something they can do overnight."

*Anthony La Malfa is a Senior Manager in the Real Estate & Hospitality Services practice in BDO Seidman's New York office. He can be reached at (212) 885-8140.*

## Year-End Tax Review: Rentals, Real Estate Sales and Gifts

By Dan DiTieri

### Rental Real Estate

For real estate professionals, losses from rental real estate activities are not subject to the passive loss rules if during a tax year:

- More than 50 percent of the taxpayer's personal services are performed in real property businesses, and
- More than 750 hours of service are performed in real property businesses.

For both of these tests, the taxpayer must materially participate in the real property businesses. If a joint return is filed, these two tests are met only if they are separately satisfied by either spouse. (However, in determining material participation, a spouse's participation is taken into account.) Services performed as an employee are ignored unless the employee owns more than 5 percent of the employer.

In determining whether a taxpayer materially participates in any real estate activities for purposes of applying this test, each interest of the taxpayer in rental real estate

must generally be treated as if it were a separate activity. However, the taxpayer may alternatively elect to treat all of his or her interests in rental real estate as a single activity. The election is irrevocable but is often necessary to qualify. A closely held C corporation will satisfy the tests if more than 50 percent of its gross receipts are derived from real property businesses in which the corporation materially participates.

Real property businesses are those engaged in real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing or brokerage.

### Sale of Principal Residence

When selling a principal residence, up to \$500,000 of gain on a joint return (up to \$250,000 on a single or separate return) can be excluded. To be eligible for the exclusion, the residence must have been owned and occupied as a principal residence at least two of the five years preceding the sale. The exclusion is available each time a principal residence is sold, but only once every two years. Special rules apply in the case of sales of a principal residence after a divorce and sales due to certain unforeseen circumstances. If a taxpayer satisfies only a portion of the two-year ownership and use requirement, the exclusion amount is reduced on a pro-rata basis if due to an unforeseen circumstance.

*Example:* Husband and wife file a joint return. They own and use a principal residence for 15 months and then move because of a job transfer. They can exclude up to \$312,500 of gain on the sale of the residence (5/8 of the \$500,000 exclusion).

*Planning Suggestions:* If you wish to sell your principal residence but are unable to do so because of unfa-

avorable market conditions, you can rent for up to three years after the date you move out and still qualify for the full exclusion. However, any depreciation claimed during the rental period will be recaptured upon sale and taxed at a 25 percent rate.

If you own appreciated rental property that you wish to sell in the future, consider moving to the property to convert it to your principal residence. You must live in the property for two of the five years preceding the sale of the property. Provided you have not sold another principal residence for the two years prior to the sale, all gain up to \$500,000 or (\$250,000) is excluded. Any prior depreciation claimed will be recaptured upon sale and taxed at a 25 percent rate.

The sale of a principal residence does not qualify for the exclusion if during the five-year period prior to the sale the property was acquired in a tax-free like-kind exchange.

### Gifts

The end of the year is the traditional time for making gifts. For 2007, you may give up to \$12,000 in cash or property, to a person without incurring any federal gift tax liability. Thus, you can make \$12,000 gifts to any number of people as you like. If you are married, you and your spouse can give \$24,000 to each person, so long as both consent to the gift or if you give community property. To qualify for the annual exclusion, the property must be given outright to the donee or put into a trust that meets certain conditions.

In addition to the annual exclusion, the lifetime unified gift tax credit allows each person to transfer a cumulative total of \$1 million without incurring any gift tax liability. Using the credit now keeps

future appreciation of the gifted property out of the donor's estate. Other than the annual exclusion and the lifetime credit, direct payments of tuition made on another person's behalf to a university or other qualified educational organization are also excluded from gift tax, as are direct payments of medical expenses to a medical care provider.

Consider using appreciated property in making gifts since any gain on sale is likely to be taxed at lower rates. It is generally unwise to give property that has declined in value. Rather, the property should be sold to realize the tax benefits of the loss.

*Dan DiTieri is a Director in the Real Estate practice in BDO Seidman's New York office. He can be reached at (212) 885-8378.*

### Financing: Lender Liability for Improper Disclosure

*By Alvin Arnold*

In a decision that affects all types of financing, a federal district court in Massachusetts ruled that a lender's disclosure to a competitor of the reasons for the lender's decision not to finance a prospective borrower's investment could constitute a tortious interference with a prospective business relationship if such action constitutes a violation of established standards in the banking industry.

ARY Jewelers LLC is part of a billion-dollar enterprise headquartered in the United Arab Emirates. The parent company is in a variety of businesses, including real estate. ARY had an opportunity to purchase the stock of Krigel's Inc., a privately owned chain of retail jewelry stores that had fallen on hard times. ARY and Krigel's entered into a stock purchase agreement. ARY sought financing for the deal from various

lenders, including IBJ Business Credit Corp., the defendant in this case. An agreement between the two was negotiated but IBJ then rescinded its offer. The reason was that IBJ learned from newspaper articles that ARY's chairman had been charged with bribery in connection with a large contract in Pakistan.

Foothill Capital Corp., a competitor of IBJ in seeking to finance ARY's acquisition of the Krigel firm, was informed by IBJ of its decision to refuse financing and the reasons for doing so. When ARY sought to restart its negotiations with Foothill, Foothill withdrew its tentative financing proposal and substituted a less favorable one that included a condition requiring disclosure of any litigation involving ARY. ARY declined to do so and ended its efforts to acquire Krigel's.

ARY then began this lawsuit, alleging that if not for the disclosure by IBJ, Foothill's earlier offer would have remained on the table and ARY would have been able to proceed with the acquisition of Krigel's stock. IBJ moved for summary judgment on the count alleging breach of confidential or fiduciary relationship.

### Elements of ARY's Claim

Under Massachusetts law, the elements of a tortious interference with an existing or prospective business relationship are: (1) a business relationship or contemplated contract of economic benefit; (2) defendant's knowledge of the relationship; (3) defendant's interference with it through improper motive or improper means; and (4) plaintiff's loss of advantage directly resulting from defendant's conduct. The court said that ARY presented competent evidence on all four elements, but that the third and fourth deserve further attention.

### Improper Motive or Means

The court said no facts suggested that IBJ acted through an improper motive, i.e., out of enmity or with the purpose of hurting ARY. With regard to improper means, however, ARY maintains that IBJ improperly shared confidential information with Foothill, since this violated banking industry confidentiality standards. Said the federal district court, "The very narrow question... is whether a violation of established standards in a trade or profession rises to the level of improper means for the purposes of tortious inter-

ference." The federal district court also held that a genuine issue exists with respect to whether ARY's damages were directly caused by IBJ. The basis for this is a deposition by an officer of IBJ that he had changed the terms of the agreement because the information from IBJ "made us nervous." Thus the case must go to trial.

Reference: *ARY Jewelers LLC v. IBJ/TC Business Credit Corp.*, 414 F. Supp. 2d 90 (D.C. Mass. 2007).

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

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.

To ensure compliance with Treasury Department regulations, we wish to inform you that any tax advice that may be contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding tax-related penalties under the Internal Revenue Code or applicable state or local tax law provisions or (ii) promoting, marketing or recommending to another party any tax-related matters addressed herein.