

Real Estate Monitor

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Investments:

NOI, Cap Rates and ROI

By Brian Bader, CPA

The past few years of frantic activity in real estate attracted many first-time investors who sought and often realized substantial profits. This was the result of rising values from well-located real estate plus the upside leverage from low interest loans. Now, however, circumstances have changed. Asking prices in many cases reflect fully valued properties, while interest rates are approaching traditional levels.

Two Key Factors

In a fully-valued market, an investor must pay careful attention to two crucial factors. The first is the projected growth of net operating income (NOI) during the expected period of ownership. The second is the likelihood that the capitalization rate at the time of sale will not be higher than that the going-in rate. The example below illustrates how these factors determine ultimate gain or loss.

For reference, bear in mind that in the period from 1978 to 2002, the average cap rate ("yield") for real estate, calculated by the National Council of Real Estate Investment Funds (NCREIF), was 7.9 percent, with a high of 9.9 percent in 1995 and a low of 6.3 percent in 1989.

All-Cash Investment

Assume an investor pays \$1 million in cash for an apartment building with NOI of \$60,000 (6 percent cap rate). Over a ten-year holding period, he anticipates rental growth of four percent annually but offsetting this is two percent annual cost for capital expenditures (CAPEX) not reflected in NOI.

At the end of ten years, annual NOI will have grown to \$71,700. If he then sells the building at the same 6 percent cap rate, the price will be \$1.2 million

(16.67 x \$71,700). This represents a total profit of \$200,000, or two percent annually on the all-cash investment of \$1 million. Total NOI over the 10 years (assuming the two percent increase in NOI each year) equals \$657,000, or approximately 6.6 percent annually. Adding the two percent annual profit gain means an average annual return of 8.6 percent.

Upside Financial Leverage

A major benefit of real estate investing is the ability to finance the major part of the investment with borrowed funds. Assume the investor can obtain a standing (non-amortizing) loan of \$700,000 at 5.5 percent interest (\$38,500 annually). Then first year cash flow is \$21,500 (\$60,000-\$38,500), or seven percent on his \$300,000 cash investment.

This will grow in the 10th year (when NOI is \$71,700) to \$33,200, or 11 percent on the \$300,000 cash investment. Over the 10 years, the total cash flow is \$272,000 (NOI of \$657,000 minus \$385,000 total interest) or an average annual return of nine percent on his \$300,000 investment.

Sale in Year 10

At the end of 10 years, the building is sold. If the cap rate has remained at 6 percent, sale proceeds will be \$1.2 million (16.67 x \$71,700). After repaying the \$700,000 loan, the investor has \$500,000, a net gain of \$200,000 over the ten years, or \$20,000 a year. This represents a return of seven percent annually on his \$300,000 investment. Adding the average annual nine percent NOI return gives a total annual return of 16 percent.

If Cap Rates Rise

Suppose, however, the cap rate over the 10 years rose to its long-term average of 7.9 percent (i.e., a buyer will expect to receive that yield on a free and clear basis). The price then

would drop to \$907,000 (12.65 x \$71,700). After paying the bank loan of \$700,000, the investor is left with \$207,000, a loss of \$93,000 on his \$300,000 investment. This equals a 3 percent annual loss on the \$300,000 investment. Subtracting this from the annual nine percent NOI return reduces the annual return to 6 percent, a sharp decline from the 16 percent had the cap rate remained unchanged.

Beware the Cap Rate Trap

As can be seen from the above example, the benefits of real estate investing – the ability to borrow the major portion of the investment and the growth of NOI over time can produce good returns, provided the cap rate on resale is no higher than the initial cap rate.

The major profits from real estate more often come from identifying locations ready for rapid growth or by converting properties to higher and more profitable uses. Such strategies most often are carried out successfully by seasoned real estate professionals.

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Leases: Reviewing Annual Operating Expense Statements

by Martha Meli

By this time, most commercial tenants with pass-through costs in their leases have received from their landlords the annual Operating Expense Reconciliation Statement. Typically prepared mid-year for the prior calendar year, the statement reflects the tenant's obligation to pay its share of increases in the total occupancy costs of the building, often the second highest expense after payroll.

Tenants today accept the idea that increasing costs constantly chip away at the landlord's profit margin that was carefully calculated into the basic rent set when the lease was executed. In order to preserve the profit margin, landlords expect the building tenants to absorb increased costs of operating the building due to higher property taxes and a higher level of services. Notwithstanding their awareness of the escalation clause in their leases, tenants often are taken by surprise when the statement shows expenses much higher than anticipated. The question that invariably comes to mind is whether increases have been properly calculated and whether some costs have been improperly included. At the very minimum, the tenant should take out the lease and compare the cost items in the reconciliation statement with the language of the operating escalation clause.

Allowed and Disallowed Items

Most office leases contain a laundry list of items for which the landlord may charge tenants, along with a list of disallowed items. Some leases describe operating expenses in more general terms. In either case, the annual statement can contain items for which tenants clearly are not obligated to pay as well as items that could be interpreted either as operating expenses or another type of expense - a capital expenditure, for example, or an expense unrelated to the operation of the building.

Some costs that should be checked carefully by the tenant include the following.

Salaries:

The landlord may include salaries paid to all of its personnel, including cleaning and security staff, managing agent, executives and other staff members. The tenant, on the other hand, will not wish to pay the

salaries of the landlord's staff (or the landlord's own salary), since these are not directly attributable to the tenant's occupancy of space. Usually, only the salaries of the managing agent and his subordinates are included in operating expenses; higher-ups are excluded. Further, when an outside management firm is used, its fees should approximate those paid by comparable buildings in the neighborhood.

Expenses for leasing space in the building:

The landlord may seek to include expenses such as advertising and promotion incurred to obtain new tenants, as well as brokerage commissions and legal and administrative expenses relating to negotiating new leases or enforcing the terms of existing leases. A tenant may argue that such expenses bear no relationship to the space the particular tenant leases in the building.

Overtime charges:

Typically a tenant using its space outside of normal business hours must reimburse the landlord for the overtime costs of HVAC (heating, ventilation, and air conditioning) and sometimes for the costs of a security guard or freight elevator. Such costs always should be excluded from the escalation charges, otherwise the landlord will be twice reimbursed.

Capital expenditures:

An operating expense clause in a lease should be very specific in distinguishing repairs and improvements from capital expenditures. Operating expenses customarily include repairs to the common areas of the building as well as to core building systems such as elevators, HVAC, lighting fixtures, wiring, security systems and sprinkler systems. On the other hand, the normal

replacement of core systems, or costs incurred to correct structural, design or engineering defects should properly be regarded as capital outlays that are the responsibility of the landlord. When an expenditure is for the purpose of modernizing a building system that will reduce operating expenses in the future, the tenant's position should be that such costs can be treated as operating expenses only if the tenant will share in future savings resulting from the improvement. One way to do this is to provide that the annual expense pass-through relating to the improvement will not exceed the amount of the annual cost savings to the tenant.

Outlays required by law:

During the lease term, new laws or regulations may require unanticipated capital outlays. For example, a new law may require the installation of equipment to improve air quality, or require the removal of asbestos or the purchase of new safety equipment. The tenant may argue that such capital costs are one of the risks of property ownership and in addition, increase the value of the building. If the tenants are required to pay such costs, the annual pass-through should be based on the useful life of the new equipment.

Other charges:

Other charges sometimes included in an operating expense reconciliation statement that should be challenged by the tenant (unless clearly authorized by the terms of the lease) include: expenses for which the landlord has been or will be reimbursed by a third party; rent payments under a ground lease; the landlord's routine corporate and administrative overhead; debt service on a mortgage or any loan, fees or penalties; and any loss of value due to any form of depreciation, including normal wear

and tear, functional depreciation and social and economic depreciation.

Grossing Up Base Year Expenses

Equally as important as analyzing the expenses included in operating costs are those that may be omitted, especially in your base year. A tenant expects that it is paying rent for a fully operational and fully serviced building. If the tenant's base year was one of the years when the building was leasing-up, a later year may show an unusual increase in the expense escalation. If expenses in the base year were not adjusted to reflect costs that would have been incurred for a fully occupied building, the tenant may be paying more than he should. Rather than reimbursing the landlord for increases in costs due to inflation, the tenant pays for the added costs associated with having more tenants in occupancy (more area to clean, more trash, etc.) The landlord may even charge a higher management fee for serving more tenants. To avoid this, the escalation clause should provide that expenses in the base year(s) should be "grossed up" to reflect normal occupancy levels.

Self-Protection

Very often a tenant takes great pains to negotiate its operating expense clause, making sure that the list of inclusions and exclusions are specific to its needs and that it contains proper gross-up language. The landlord or its managing agent may not review each tenant's lease before preparing the annual escalation billing. What complicates this further is turnover of owners and managing agents after a sale of a building, or even the natural internal turnover of an owner's accounting staff. Tenants can protect themselves from paying more than their fair share of expenses by retaining audi-

tors whose sole purpose is to review the specific calculation of an operating expense escalation.

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Hospitality: Buy, Sell, Build?

After a period of strong gains in RevPar (revenue per average room), the hospitality industry (depending on your point of view) is in a "frothy" state, or is a good place to invest. Gisle Sarheim, a senior associate in HVS International's New York office, recently examined the state of the hospitality market and whether it is time to buy, sell, build or be bought in a report titled "U.S. Hotel Investments: State of the Union 2006."

Buy Hotels

Both large and small deals in 2005 had one thing in common—low cap rates, particularly in the major metro markets. A total of 126 transactions in major metropolitan markets last year had an average cap rate of only 6.6 percent. HVS International Data also indicated that New York City cap rates averaged 5.3 percent last year, based on 13 sales with reported cap rates. (In the 2000-2002 period, cap rates in the U.S. exceeded 11 percent.) However, rising interest rates and improving cash flows in the first quarter of 2006 have caused a slight rise in cap rates, with HVS data indicating an average cap rate of 7.3 percent on 17 transactions.

Debt Financing Available

One reason for the low cap rates for hospitality properties has been the combination of low-cost financing and high loan-to-value (LTV) ratios. These in turn are attributable to a surge in CMBS issues containing hospitality loans. This represents a major turnaround from the large

number of delinquent loans originating in the 1996-1998 period that resulted in over \$1 billion in loan defaults in 2003, equal to 31 percent of total CMBS defaults. In sharp contrast, hotel loans in 2004 amounted to 7 percent of all CMBS loans and 9.4 percent in 2005. At the same time, overall CMBS issuance has increased substantially in the past two years.

Suggested Investments

According to the HVS report, "Despite high per-room prices and pressured yields, there are still numerous opportunities in the market for successful acquisitions." These primarily are properties that suffered from falling profits and/or defaulted on loans. Such properties may need a facelift, a repositioning or a change of brand. But with necessary capital expenditures combined with an experienced management team, these can often be around to yield healthy returns.

Sell

Last year, public companies dominated the sell side as they continued to transform themselves into pure management and franchise companies. This improved their image with Wall Street, which never favored the traditional "hotel company" model that combined ownership of real estate assets with a hotel operating company. The fact that a major portion of value was tied to slow growing real estate assets hindered the growth of the companies even though the "own and operate" model permits the maximum control of hotel assets. Such major corporations as Hilton, Starwood, InterContinental and Marriott disposed of a substantial number of their assets and used the proceeds to repay debt and fuel further growth, while at the same time ensuring control of the hotel oper-

ations with lease-back and management agreements.

In the current seller's market, private operators should utilize the opportunity to sell properties in markets that are at risk of oversupply. Sarheim points out that the cyclical nature of hotel real estate should never be underestimated. While external influences can impact hotel performance, the ultimate curse in the industry is oversupply.

In considering whether to sell a property, the questions to ask are whether RevPar is in line with the market, whether the property is in good condition or needs upgrades and renovations, and whether a strong base of loyal customers are likely to stay with the hotel indefinitely.

Build

Four years of limited new supply combined with the current impressive industry fundamentals "is an open invitation for construction of new supply," according to the report. Construction funds also are more readily available, although sharp increases in construction costs may put a damper on the next building boom. According to the Construction Cost Index, published by Turner Construction, construction costs rose by 5.5 percent in 2004 and another 9.5 percent in 2005, with continued increases expected this year.

Despite the negatives, the overall supply pipeline at the end of the first quarter of this year consisted of more than 3,300 projects totaling 448,000 rooms, the highest pipeline total since the record year of 1998. (Only a portion of these new rooms will come on line this year.) To some extent, the new hotel rooms will replace those converted to private condominium units. As with other property types, the best construction opportunities are those in markets with significant barriers to entry.

Manhattan, New York is the best example; hotels there had an occupancy rate of 85 percent and average room rate of around \$232 in 2005.

"U.S. Hotel Investments: State of the Union 2006" can be accessed at www.fivsinternational.com.

Family Wealth Planning: Real Estate and the Private Annuity

By Stephanie Hunt

A combination of circumstances is causing an increasing interest in the private real estate annuity as a way to reduce or defer taxes on gains. On the one hand, many investors have seen the value of their real estate holdings rise substantially over the past few years, which means that a sale will result in a substantial capital gains tax even at the current 15 percent rate. On the other hand, the unwillingness of Congress to terminate estate taxes means that passing the property by inheritance could mean a significant sum will be paid upon the death of the present owner. (Currently, the exemption is \$2 million after which the tax rate rises sharply to as high as 46 percent.) Finally, the IRS has been showing an increasing interest in private annuities, believing that in many cases the tax rules are not properly followed.

Annuity Benefits

Owners of real estate portfolios should consider the benefits of a private annuity with their children (or other younger family members). An annuity, while keeping property within the family, can enable the older family member to continue receiving income and at the same time exclude the real property from his estate. Put another way, an annuity permits the family to retain today's real estate values for tax purposes rather than date-of-death value, which could be much higher.

What Is an Annuity?

An annuity is a transfer of property from one party (the annuitant) to another party (the obligor) in exchange for the obligor's promise to pay a specified amount of money annually (hence the term "annuity"). A private annuity is one between the annuitant and someone not in the business of selling annuities. The period of time over which payments must be made can be the lifetime of the annuitant; the lifetime of the survivor of the annuitant and spouse; or for a term of years at least equal to the annuitant's life expectancy.

Example: A father owns an apartment house with a fair market value of \$500,000. He wishes to remove the property from his taxable estate while at the same time avoiding a large capital gains tax that would be due on a straight sale. So he transfers the property to his daughter in exchange for her promise to pay her father a fixed sum each year for the rest of his life.

How Much is the Annuity?

Assume the property has an existing mortgage of \$250,000, so that the current equity is \$250,000. It is this sum that determines how much the daughter must pay over to her father (in the form of an annuity) over the balance of his life. The amount of each annual payment depends on the life expectancy of the annuitant and the applicable federal rate (AFR) that changes periodically and is based on current interest rates.

The IRS has tables from which the annual payment can be determined. If the father is 65, the June 2006 annuity factor is 9.7151. (See Treas. Reg. S 20.2031-7). Under this formula, the daughter must agree to pay her father \$25,733 each year for the rest of his life (even if he outlives his life expectancy). The sum is a

result of dividing the equity of \$250,000 by 9.7151.

Advantage of Private Annuities

In the example just given, the following benefits are achieved by the parties:

- *Estate exclusion.* The property transferred by the annuitant is excluded from his estate since he no longer owns it and (in the language of the tax law) has received adequate and full consideration in money or money's worth. His daughter benefits from any future appreciation.
- *No gift tax.* No gift tax is payable by the annuitant because the transfer is structured as a sale. Nor is his unified credit against tax reduced, provided the property is accurately valued. (Any undervaluation can give rise to a gift tax or reduction of the unified credit.)
- *Deferral of gains tax.* If the property has appreciated in value, the annuitant need not pay capital gains tax at the time of the transfer. Instead, part of each future annuity payment will be treated as capital gain; part as a return of principal to the annuitant; and the rest as ordinary income until the annuitant has recovered his tax basis in the property. All subsequent payments will be ordinary income.
- *Non-taxable gain.* In the event the annuitant dies before the annuity payments equal the full value of the property, any remaining untaxed gain will escape tax.
- *No initial cash.* The obligor, usually a younger family member, need not pay any cash at the time the transfer is made.

A private annuity will not make sense if the annuitant's taxable estate will not exceed \$2 million (the current exemption amount equivalent to the unified credit). In

the case of a husband and wife, their combined non-taxable estate can reach \$4 million, provided each one will have an estate at least equal to \$2 million.

Will the Obligor Perform?

A disadvantage of a private annuity is that the obligor's promise to pay the annuity cannot be secured by a mortgage on the property or be funded by a specific charge against any source of cash such as the rent income from the property. So if parent and child have a falling out or the child is unable to make the payments for any reason, the parent has no recourse except a lawsuit, which may be fruitless if the child has no assets. Another risk of a private annuity is that the parent will survive the child. The child's estate then must continue to make the annuity payments out of the estate assets.

One way to reduce the risk of future unpaid amounts is a refinancing of the property by the parent before the transfer to the child. The refinancing proceeds will be tax-free to the parent if the new loan does not exceed the parent's basis in the property. After the refinancing, the amount of the annuity will be reduced because the transferred equity will be lower in amount.

Another way to reduce the risk of nonpayment if the child predeceases the parent is to have another family member take out (and be the beneficiary of) a life insurance policy on the child's life, with the understanding that any insurance proceeds will be used to make annuity payments to the father. However, the obligation of the other family member to so use the insurance cannot be legally binding, just as the annuity itself cannot be backed by security.

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Owning Real Estate: The Limited Liability Company

By Dan DiTieri, CPA

Since their first appearance 13 years ago, limited liability companies (LLCs) have become a popular form of real estate ownership in all 50 states. (While state statutes are based on the Uniform Limited Liability Company Act, they may differ in some particulars.) An LLC is an unincorporated form of business that typically provides for limited liability of its managers and owners (called members) and for flow-through tax treatment. An LLC is similar in some ways to a general partnership and in other ways to a limited partnership.

Like a corporation, an LLC is considered a foreign business entity in every state other than its state of formation and so must register to do business outside its home state. Additionally, analogous to a corporation, an LLC is considered a separate legal entity that can enter into contracts, hold title to property, and sue (and be sued) in its own name. However, LLCs are unlike corporations in some important ways. For example, ownership interests are not freely transferable. Moreover, the duration of the business is not perpetual; the LLC, like a general partnership, is subject to dissolution upon the occurrence of certain events.

LLC and S Corporations

LLCs are free of certain restrictions that limit the usefulness of S corporations. For example, no limit is imposed on the number of LLC members and the LLC can create different classes of memberships, including preferred and subordinated interests in capital, profits and cash flow. By comparison, an S corporation is limited to one class of stock

and can have a limited number of shareholders. Finally, only individuals or certain trusts may be S corporation shareholders, whereas shares in an LLC may be held by other LLCs or by corporations. This permits LLC members to further limit their liability to an amount less than the investment in the primary LLC.

Flow-Through Tax Treatment

One of the most important attributes of an LLC is flow-through tax treatment. Like partnerships and S corporations, LLCs are not subject to federal income tax at the entity level; instead, all items of income, loss, deductions, and the like flow through to and are reported by the owners.

Centralized Management

An LLC is a separate legal entity that acts through its authorized agents. The owners of an LLC are called members. Most statutes provide that an LLC can be member-managed or managed by non-owner professional managers. An LLC will be considered to have centralized management whenever a group consisting of fewer than all the members has continuing exclusive authority to make management decisions.

Lender Concerns

It is important for lenders to ensure that members of an LLC borrower have dealt appropriately with issues relating to disassociation of a member (and the purchase of his or her interest) or dissolution of the LLC itself. This is the same concern lenders have with general partnerships.

The lender needs assurance that if the LLC is required to purchase a disassociating member's interest in the business, this will not cause financial disruption to the company. The Operating Agreement (the governing document for an LLC), should

provide a valuation formula so that costly litigation concerning can be avoided. In addition, payments by the LLC should be structured over a period of time so that raising the necessary cash does not require liquidation of business assets.

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Commercial Real Estate: Bright Outlook

By Alvin Arnold

Midway through the year, the current Commercial Real Estate Outlook of the National Association of Realtors (NAR), sees a healthy demand for space driving commercial real estate markets. The NAR represents more than 1.3 million members involved in all aspects of residential and commercial real estate and its forecast covers the five major commercial sectors: office, industrial, retail, multifamily, and hospitality. Market data was provided by Torto Wheaton Research and Real Capital Analytics.

Office Markets

Rising oil prices and slower job growth will dampen expectations for the office market, but vacancy rates still are likely to drop to an average of 12.7 percent in the fourth quarter of the year from 13.6 percent last year. Office rents are forecast to rise 4.4 percent this year.

Large institutional investors and pension funds returned to the office market in the first quarter, more than doubling the amount spent in all of 2005. Top markets were Manhattan, Chicago, Los Angeles, San Francisco, Northern Virginia and Washington, D.C.

In a separate report, GRA National Real Estate Index reported that CBD office cap rates in the first quarter dropped to 6.8 percent from 7.2 percent in the last quarter of 2005, while

cap rates for suburban office dropped to 7.0 percent from 7.4 percent in the same period.

Retail Market

The NAR report says that retail market absorption is matching new supply so that vacancy rates are projected to be stable for the balance of this year at an average of 7.8 percent, slightly higher than the 7.2 percent in the last quarter of 2005. Average rent is likely to grow less than one percent this year. Higher energy costs and slower home price appreciation will hold back consumer spending, while overbuilding and fallout from mergers and acquisitions are impacting certain markets, including regional shopping centers.

According to GRA National Real Estate Index, retail cap rates dropped to 7.1 percent in the first quarter, down from 7.7 percent in the last quarter of 2005.

Apartment Market

The NAR Outlook sees rental apartment vacancy rates in the fourth quarter averaging 5.7 percent compared to 6.2 percent at the end of 2005. Average rent is forecast to rise 4.1 percent this year compared with 2.9 percent last year.

On the one hand, conversion of apartments for condos is waning somewhat, while on the other hand, a slight softening in the housing market is boosting rental demand. Concerns about job security are playing a role in keeping some people in the rental marketplace. The top markets for apartment investment over the last year were Manhattan, Phoenix, Los Angeles, Tampa, Orlando and Atlanta.

According to GRA National Real Estate Index, cap rates for Class A apartments dropped to 6.0 percent in the first quarter, down from 6.5 percent in the last quarter of 2005. Cap

rates for Class B apartments dropped from 7.4 percent to 7.0 percent.

Industrial Market

According to the NAR, industrial vacancy rates are forecast to decline to an average 9.5 percent during the second half of the year from 9.9 percent in the final quarter of 2005. New construction is increasing, but this is matched by space absorption. Trade with China continues to fuel demand for warehouse and distribution space. While market fundamentals appear to be healthy, industrial rents may increase only 1.9 percent this year. The lowest vacancy rates are in West Palm Beach, Florida, Los Angeles, Fort Lauderdale, Las Vegas, Miami and Orange County, California, all with rates of 5.4 percent or less.

According to GRA National Real Estate Index, cap rates for warehouse properties dropped to 7.5 percent in the first quarter from 8.0 percent in the final quarter of 2006.

Hospitality Market

The NAR says hotel occupancy should reach 63.4 percent this year, just under the 64.5 percent of last year. Revenue per available room (RevPar) is projected to reach \$72.37 this year, up 7.5 percent from \$70.47 last year. The hotel inventory should rise by about 17,500 rooms this year, up from 5,600 last year. Markets with the highest amount of construction include Houston, Orlando, Fort Worth, Washington, D.C., Atlanta and San Diego,

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