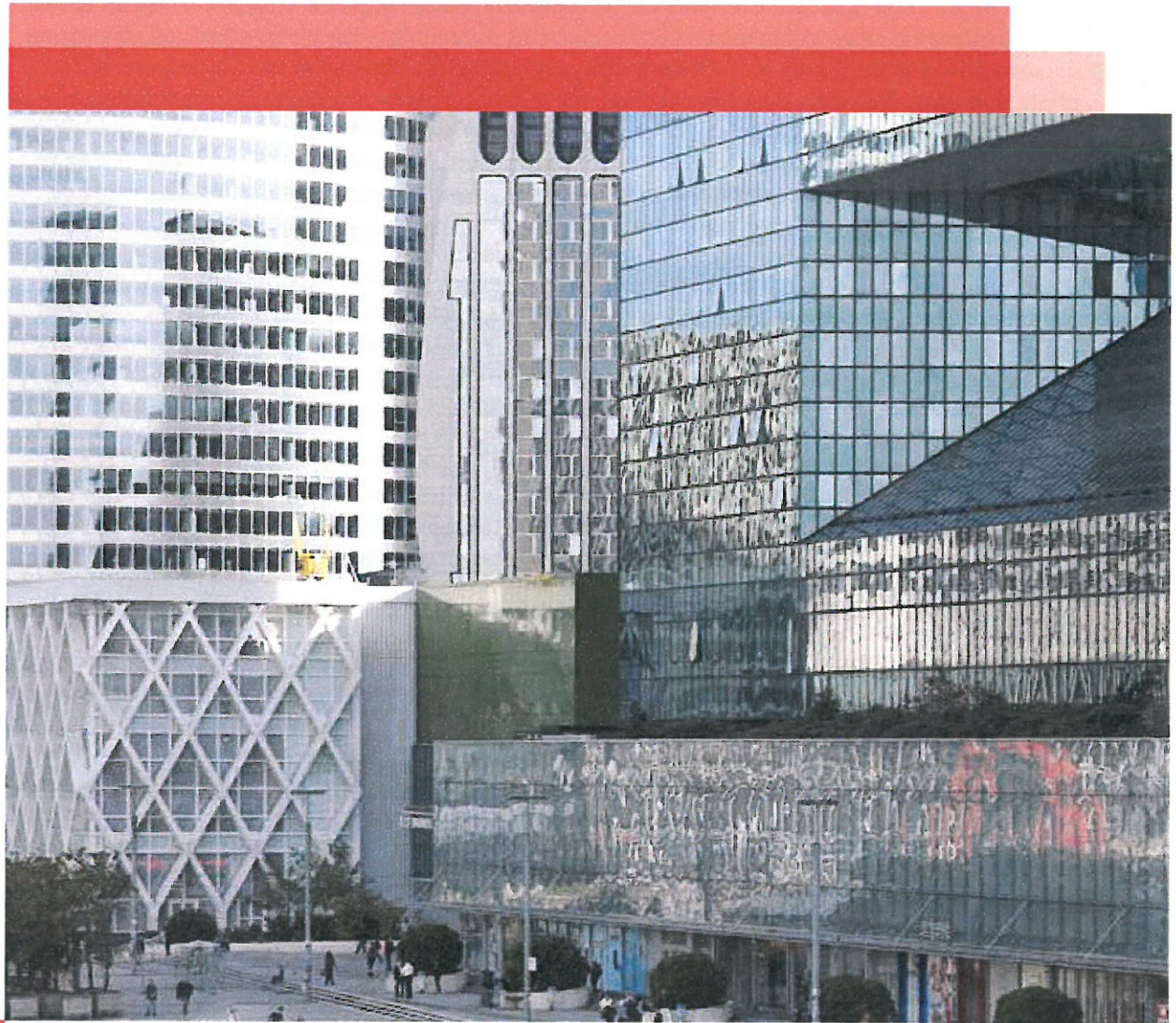


US Real Estate Insights

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Dear Clients and Friends,

On behalf of PwC's Real Estate Practice, it is our pleasure to offer another edition of US Real Estate Insights. This publication provides perspectives on the latest market and economic trends, regulatory activities and legislative changes affecting the real estate industry, as well as informed views of the most current developments in operations, business strategy, taxation, compliance and financing.

Consistent with our global vision statement – to build trust and work toward solutions to the world's biggest problems – we continue to bring you thought leadership that is relevant to your industry, while also speaking to your topical needs related to accounting and financial trends and updates.

In this edition of US Real Estate Insights we are especially pleased to provide insightful articles in two areas of increased focus within the real estate investing community – the global search for investment opportunities and the impact of technology and generational preferences on the way commercial real estate is utilized. Following the financial crisis, many investors grew accustomed to identifying distressed investments as opportunities to enhance returns. In "Identifying real property investment opportunities in Spain," David Criado and Matthew Rosenberg discuss how, following a severe economic downturn, a combination of structural reforms and a change in the trends of economic indicators has attracted investors to the risk reward profile of distressed investment opportunities within this Eurozone country. Additionally, in "Where do we grow from here? The impact of millennials on urban real estate," with input from Richard Barkham, CBRE's Global Chief Economist, and Winston Fisher, Partner at Fisher Brothers, Willem VanDooijeweert discusses how landlords and corporations may adjust the way they design their commercial real estate spaces and real estate strategies. These changes are influenced by the generational preferences of Millennials as they become a larger percentage of the workforce.

We also encourage you to read our flagship thought leadership piece, *Emerging Trends in Real Estate 2015*. As confidence returns to real estate, the industry faces a number of fundamental shifts that will shape its future. To help real estate managers and the investment community better plan, we have looked into the likely changes in the real estate landscape over the coming years and identified the key trends which, we believe, will have profound implications for real estate investment and development.

We hope you will find US Real Estate Insights to be informative and helpful to you in your business.

As always, we encourage you to share your thoughts, opinions and suggestions. For more information or to be added to our distribution list, please feel free to contact the authors of this edition's articles or your local PwC representative.



A handwritten signature in black ink, appearing to read 'Byron Carlock, Jr.'.

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Where do we grow from here? The impact of millennials on urban real estate

by Willem VanDooijeweert



A couple of years ago, I walked into the dining room to bring my son dinner, and as I approached the table, I heard the familiar voice of his friend Marcus shouting; “Hi, Mr. V.” Ironically, Marcus was present yet nowhere to be found. My son had strategically placed a tablet across the table and was video-chatting with his friend while they both prepared to scarf down a late meal after soccer practice. The idea of a virtual dinner was mind-boggling to me, but also a lesson in efficiency. They discussed everything from school to soccer, polished off homework, shared files and used their smart phones to organize a soccer-video game party where a group of friends would convene later to play online simultaneously.

Two hours later, everything was done!

Earlier generations, such as my own Generation X, were not instantly connected and a great deal of time was lost travelling back and forth to places like malls, libraries, record stores and each other’s houses. Weather often cancelled our plans, and information was so far from our fingertips that school reports took weeks, versus hours to complete. Our

idea of sharing was a party telephone line using multiple homes accessible from one rotary phone in the kitchen. If we wanted to take a “selfie,” the process would span a month including three trips to the store to buy a roll of film, drop it off for development, then pick up prints, which we would review and pay for expensive duplicates to be snail-mailed to select friends or families. Nothing was instant, except the vitamin-fortified breakfast drink, and the idea of getting everything done in an evening was not fathomable.

To keep up with the changing workforce and rapidly-changing technology, many organizations are beginning to scrutinize where and how things get done through a physical and virtual network of connections to understand the evolution of people and place. When signing a fifteen year lease, organizations are constructing an environment not only to meet the needs of the current workforce but also to be suitable for today’s teenagers who will start entering the workforce five years from now. Imagine designing office space catering to a new generation of

multi-tasking, hyper-connected employees who rarely use E-mail and will likely:

- Share everything from workspace to automobiles;
- Buy groceries without going to the supermarket;
- Hang out without leaving their residences;
- Train behind computers without going to a classroom; and
- Have face-to-face meetings without shaking hands in person.

To real estate professionals educated under the mantra of “location, location, location,” the idea of building infrastructure for employees accustomed to visiting places that do not physically exist presents a paradox challenging companies to rethink the definition of place.

The ability of people to connect with colleagues worldwide from almost anywhere has some real estate experts predicting an Arm’chair’meggedon with employees isolated in their residences collaborating on work products without ever going to the office. The corresponding outward migration of staff from the office to remote locations coupled with companies building more efficient infrastructure will then result in a decreased demand for real estate.

As the workforce demographics change, tenants’ demand for traditional office space will change; however, landlords need not panic and liquidate

their brick and mortar assets for space in the clouds. Building owners clinging to the old school *Field of Dreams* philosophy of “if you build it they will come,” could likely suffer declining returns on their investments. Assets positioned to take advantage of the changing demographics and megatrends, however, may be better positioned to reap the benefits of companies who demand a new type of space. Just as today’s teenagers do not go to a record store to buy music, they will not aspire to visit an obsolete office building or building full of offices. The big question for an evolving economy of workers who believe work is a thing and not a place “Where will they go?”

Today’s millennials (born between 1980 and 2000) are intelligent, global-minded, environmentally-sensitive, highly-social multitaskers, who have hundreds and sometimes thousands of online friends and followers. These network-minded individuals will work most efficiently in buildings and spaces designed to foster connections and knowledge transfer. As organizations embrace mobility, staff will visit the office for specific needs, challenging end users to consider not only designing multipurpose space encouraging employee engagement, but also with finding locations to which people will want to come.

Modern corporate real estate professionals charged with the mission of finding homes for employees who demand more from their infrastructure can no longer determine space requirements based on simple metrics such as square

foot per person. Instead, they use sophisticated occupancy tracking tools to provide data for analytical tools used to determine space utilization rates and who is coming into the office. To maximize employee engagement and reduce turnover, firms may rethink the traditional approach of hiring architects to develop designs based on agreed upon company standards or “space mix.” Rather, real estate departments, human resources and information technology functions in tangent with the businesses that they serve may partner with architectural firms to develop intricate programs to determine the ideal “place mix.” CBRE Group, a leading global real estate advisory firm, in its article *3 Workspace Trends to Watch for in 2013 (and Beyond)* anticipates that companies will need to consider adding a “Chief of Work Officer” into the C-suite coordinating those three departments with an eye of attracting and retaining top talent.

“Place mix” consists of the places an employee occupies while working across two major dimensions:

1. **Virtual place:** the virtual places employees visit using their technological devices to complete activities such as work, communication, socialization, networking, training and research
2. **Physical place:** the physical spaces employees inhabit such as client sites, home offices, coffee shops, airplanes/airports, green spaces, hotels, or company owned real estate

Creating the ideal “Place Mix” requires examining multiple data sources and working with the business lines to develop employee behavioral profiles, which provide the foundation for programming, design and site selection. These behavioral profiles continue to support the ongoing trend of urbanization, offering savvy landlords the opportunity to provide an experience meeting the needs of the future workforce. To understand why, it may be easier to journey into the heads of the new millennials and consider how the city center experience and creative office space designs will satisfy their needs across the following key attributes:

1. Experience craving
2. Hyperconnectivity
3. Global minded

Though millennials represent an increasing share of the future workforce, and thus the focus of this article, it is important to note that many major cities have rebounded even after the dot.com crash. Well before the millennials first entered the workforce, corporations were already moving

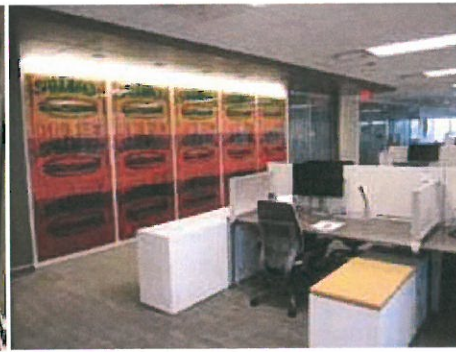
globally, pushing the envelope on technologies and building the network infrastructure, which supported the growth of the online commerce and communication. It is not uncommon to see long-tenured professionals using laptops, mobile devices and tablets, leveraging a host of applications and software tools designed to help them be more efficient and productive. The gap between millennials and Generation X is not as wide as people think.

Readers are also cautioned that the attributes ascribed to millennials herein, come from a perspective of professionals with experience in financial services, technology sector, post-education and media industries. These industries have experienced dramatic change in how they work ranging from content delivery to leveraging global outsourced solutions. The attributes outlined above, however, are reflective of a generation of young people who are and will be entering all forms of industry, and helping to change the landscape of how goods and services will be delivered in the future. Any industry from manufacturing to healthcare can

benefit from understanding how their emerging work force acts and thinks.

Experience craving

Millennials place a high priority on workplace culture and desire a work environment that emphasizes teamwork and a sense of community.¹ Accordingly, the building, the office space and its amenities should synergistically blend into the community to provide a unique experience that gives employees a reason to come into the office and more importantly, enjoy the work. For instance, in PwC’s Philadelphia office, full scale wall-graphics and artwork were carefully selected by the architects and the local office design committee to provide a distinctive “Philadelphia” feel and sense of connection to the city and its rich heritage. Designed and built to national standards, the environment provides a mix of collaborative, free address and focus spaces allowing the employees to leverage the different types of settings needed to complete work.



1 PwC’s NextGen: A global generational study 2013 Summary and compendium of findings, p 8.

Since millennials are accustomed to sharing, various seat types are reserved through web-based and mobile applications allowing for easy access where and when required. To further enhance the experience, each space is designed to “work harder,” or serve multiple purposes. For example, offices are designed as team rooms and are equipped with wireless display monitors, which automatically connect to laptops and mobile devices. The combination of flexible furniture and technology enables staff to utilize the rooms as focus areas, video rooms, overflow seating for seasonal or peak periods, interview rooms, and conference rooms. By providing a flexible environment where a host of activities can be completed in various settings using multiple devices over state-of-the-art wireless platform, the office space attempts to deliver energetic space that maximizes the work experience of the employees.

However, even versatile space brimming with “cool” factor is not enough to draw young professionals. The office location, commuter access, building quality and amenities need to augment the space to create a dynamic environment that millennials crave. Landlords will continually need to rethink the strategies for their buildings and market the overall unique experience of each one to tenants. When asking Winston Fisher (a partner primarily responsible for finance, acquisitions and new development at the Fisher Brothers) about how his role as a landlord has changed over the past few years, he

replied, ***“We are no longer just a rent collector. We are now a full service provider from the infrastructure of our buildings to the services we provide our tenants. Each building requires a different mindset.”***

Urban landlords can offer space to businesses that enhances the experience of their employees at three levels. Within the building, tenants can leverage special use spaces such as sundry shops, cafeterias, conference rooms, lobby space and retail. At street level, tenants can access a vast array of amenities such as mass transit stops, retail, and restaurants offering everything from fine cuisine to late-night delivery during busy periods. At the city level, employees enjoy access to arts, housing, theater, green spaces, museums and everything urban life has to offer. Echoing the importance of these three levels coming together to create an urban center experience, Fisher claims, “Everything is designed around collaboration. We’re green, we’re efficient ... from a tenant, landlord and city perspective.”

Hyperconnectivity

During one of my son’s freshman soccer games, the team’s left back made a spectacular tackle that prevented the opposition from scoring a goal. When the cheering subsided and the ball was still in play, his mother yelled that he was awesome, and he calmly responded, “Thanks, now can I have my phone back?”

Most anyone with a teenager at home can tell you, taking a phone away is a

travesty of epic proportions. Today’s youth are continually connected and their mobile devices, which ping more than the roof of a car in a hail storm, serve as arteries into the heart of their social networks. Similarly, where employees work must foster connectivity in order to engage employees and reduce turnover.

The term “office building” symbolizes a compartmentalized view of space; rather than the more holistic depiction of “network buildings.” Since employees are no longer tied to desktop computers linked to local networks and can complete focus work almost anywhere, office space should be designed to foster distinctive connections. Collaborative offices offer multiple spaces allowing for both formal and informal interaction. In addition to conference rooms for formal meetings, the environment must offer spaces where millennials can spontaneously connect to socialize, learn and ideate. Free address spaces such as internet cafes and teaming areas, supplemented by video technology, wall talkers and other devices designed to facilitate interactions are critical for companies whose services depend on creativity of its employees and knowledge transfer.

To increase collaboration, CBRE transitioned its Downtown Los Angeles high-rise office into the new global corporate headquarters, which is the winner of this year’s CoreNet Global Innovator’s Award—a fluid, technologically-advanced, inclusive workplace, and the first office in the world to be WELL Pilot Certified.

Realizing that CBRE's existing space was 51% underutilized, the company was primed to change the game. Addressing the goal of increasing productivity and collaboration, CBRE re-envisioned a completely new and innovative workplace concept for its new global headquarters. Through several months of exploration, research, benchmarking tours, and focus groups, the emerging design objective was to create an innovative, 100% free-address environment connecting two floors in an urban high rise. The result was 48,000 square feet of office space with no assigned offices or work stations, and sixteen different types of spaces to accommodate both individual and collaborative work, as well as informal spaces that encourage interaction between departments. A year after moving in, an employee survey showed that 92 percent of employees report a positive effect on their health and well-being and 83 percent say they feel more productive.

Connectivity does not end at the office. To recruit and retain the best talent, companies should consider locations that develop connections beyond the office walls like cities, which rarely sleep and provide a highly diverse environment to network. Cities with robust infrastructure where people can easily move by foot, bicycle or mass transit systems provide a physical network mirroring the internet, allowing young professionals to move about quickly and connect at locations from favorite happy hour spots to athletic clubs. Universities and other continuing education providers are

readily accessible, making urban locations ideal for millennials, who are able to pursue their professional designations and various degrees while building their careers. Further, the high concentrations of industries such as entertainment, banking and financial services in cities such as New York help the millennials meet industry peers, build client relationships, join professional organizations and advance their careers.

Global minded

One of the advantages the millennials have enjoyed through hyperconnectivity is a lifetime of access to global information sources. Growing up with the internet of everything, millennials do not have an outside-looking-in perspective, rather with a computer or portable device they can at any time link to and become a strand on the world wide web. This strand does not simply provide a one way link to a virtual network, but to a lively community of billions of people who share common interests or shared experience. In many cases, such as the gaming community or image/video sharing sites, language is not a barrier allowing people to connect in new ways where the experience becomes the shared mode of communication. Further, at the end of every strand is a unique individual, who not only has access to this content, but the ability to upload and download different types of audio and visual information. Anyone who has ever sent a Snap Chat or viewed an online video can understand that paradigm shift is happening where

businesses are controlling less and less of the content on line and the people are empowered to drive change. The media and retail industry has felt this shift hard, and those that have weathered the storm have figured out a way to balance both the physical and virtual connection to provide the best possible experience for their consumers.

Charles Darwin is known for advocating that maximum diversity supports maximum life. The rise of the Internet will likely support growth in urban centers by providing culturally diverse hubs teeming with life where people can physically connect. Richard Barkham, CBRE's Global Chief Economist, notes this parallel and sees, "The world economy is in a period where both physical and virtual infrastructure meet to minimize cost and maximize creativity. Understanding those trends will be crucial for businesses to construct solutions for their people." As the web draws in users, commerce, finance, entertainment, education and tourism have attracted people to major cities for thousands of years and there is no reason to believe that growth will slow down any time soon. Historically, large multinational corporations have a presence in all the major markets and are constantly looking for top notch talent to help expand their businesses. As more millennials work for global firms, they will be exposed to new cuisines, cultures, languages, arts and customs, augmenting their internet networks with personal connections and building social skills. These

intangible skills are necessary as their work experience grows and they travel abroad to share best practices and develop integrated global business platforms.

When asked what attracts people to work in a city environment like New York, Fisher responded, “New York has a concentration of different cultures, which breeds collaboration. Different cultures plus collaboration lead to cutting edge innovation, which is what New York is all about. I like to call it ‘cross pollination.’ People need to gather and collaborate. This is what breeds success.” The millennials have grown up on a foundation of sharing and trust, allowing businesses to operate without storefronts, share distribution channels and reach customers in non-trade restricted countries all over the world. As the markets expand and channels widen, the urban centers will continue to see demand from itinerant workers coming in and out of the cities to make connections and expand their businesses.

So where do we grow from here?

As we adapt to a mobile, high-tech workforce, employees will want a mix of infrastructure allowing them to optimize their “place mix.” Corporations will likely cut their “physical place” or traditional real estate as much as fifty percent and focus on building office space, which creates an environment of shared spaces serving various purposes allowing employees to work in multiple settings and complete different activities. In turn for shedding physical space, employees will need technologies such as laptops and mobile devices affording them more access, learning, and collaboration in virtual space. Office space should be designed to match space utilization and the behavioral profiles of businesses rather than against outdated benchmarks like square foot per person or staff to workspace ratios. Finally, these offices should foster connections, knowledge transfer, socialization and diversity to create an experience where people will benefit from coming into work.

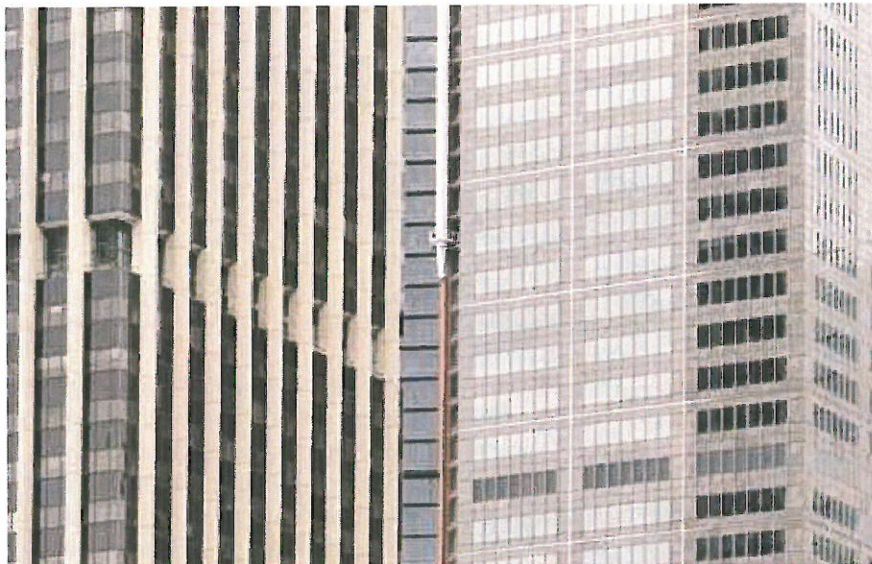
Though demands for physical space may diminish, the decline will likely be hardest felt in outdated buildings with limited amenities or differentiators providing unique experiences for tenants. As companies reduce their physical footprint, some may opt to pay more for higher quality or repositioned office buildings that create a unique experience the millennials crave. New developments may also benefit as companies move from lower quality buildings with outdated infrastructure to green buildings with more efficient floorplates. In addition to the traditional urban model, many cities are expanding their infrastructure and amenities by revitalizing areas where the arts, parks, retail and residential growth may help offer the lively experience that young professionals crave. As a result, landlords understanding these trends and positioning their buildings to capitalize changing workforce demands may be better positioned to reap the benefits; whereas, those that fail to do so may find it increasingly difficult to attract tenants at premium rates.

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Identifying real property investment opportunities in Spain

by David Criado and
Matthew Rosenberg



As value in core domestic markets has become harder to identify, the need and desire of investors to look beyond their home markets to search for investment opportunities has grown. This change in the investing landscape appears to have led many in the real estate investment community to re-evaluate their international investment profile. Of particular focus are those regions which are believed to be nearing the bottom or coming out of their financial crisis. This is because, in many cases, financial crisis' experienced by different economic environments across the globe have led to depressed asset prices. In this regard, since the pace of economic and real estate recoveries has been uneven, some investors are drawn to the potential risk adjusted returns that are presented in certain of these international markets. Many institutional investors have been drawn to Spain, where a real estate bubble has been deflating since 2008.

Background

During the period from 1996 to 2007, the Spanish real estate market endured a significant increase in the price of real estate. According to Global Property Guide, national average home prices increased by

197% in nominal terms, one of Europe's highest home price increases during that period.¹ The growth in home prices has been credited to numerous factors including high demand and the availability of credit.

Increased domestic demand can be credited to high Spanish homeownership rates and changes in the international environment after the introduction of the Euro. According to an International Monetary Fund (IMF) whitepaper, domestic policies, dating back to the 1960s and 1970s, stimulated demand for real estate, such as favorable fiscal treatment of homeownership through tax legislation as well as legal uncertainties and difficulties that owners encountered to evict problem tenants. This is evidenced through a homeownership rate of approximately 80% in Spain.² As a result, one could say that homeownership is part of

1 "Spain's Housing Market is Recovering." *Global Property Guide*. N.p., 20 July 2014. Web. 8 Sept 2014.

2 "Technical Note on Housing Prices, Household Debt, and Financial Stability." *Spain: Financial Sector Assessment Program—Technical Note— Housing Prices, Household Debt, and Financial Stability* (2006): n. pag. www.imf.org. International Monetary Fund, May 2006. Web. 8 Sept. 2014.

the Spanish psyche. Moreover, during this period, demand for real estate was driven by the creation of approximately five million jobs during the ten year span, record levels of immigration, and foreign real estate investment since the introduction of the Euro, which resulted in easier cross-country flow of capital.³

Further, the availability and cost of credit made homeownership a more attainable goal for many Spaniards. During the period leading up to the bubble, credit institutions were providing mortgages with higher historical loan-to-value (LTV) ratios, at lower interest rates, and for longer terms than had previously been encountered. Typical residential mortgage loans on primary residences were issued at LTVs of 80-100% and at Euribor + 40-85bps, while Euribor rates floated between 200 and 300 bps from 2003 to 2006. Moreover, lending terms extended for as long as 40 years.^{1,3} This made investing in homeownership more attainable and attractive for Spaniards. However, the vast majority of these mortgages were at variable rates², which meant that a slight change in the Euribor could have a dramatic effect on a borrower's ability to continue to pay debt service.

Inevitably, the financial crisis in the US spread to Europe and Spain's housing market began to crash, along with its economy. From 2008 through

2013, the real estate market suffered price declines of over 35%.¹ Financial institutions suffered terrible losses, the availability of credit froze, real estate construction stopped, unemployment soared above 25%, and GDP fell dramatically. After years without seeing improvements in the economy, in 2011, the government and regulators began to take remedial actions.

Market reforms

The Spanish market adjustments were agreed on between the European Stability Mechanism (ESM), Kingdom of Spain, The Bank of Spain, and Fondo De Reestructuración Ordenada Bancaria (FROB) and monitored by the European Union, the European Central Bank (ECB) and the International Monetary Fund. Unlike the bailouts of Greece and Ireland, Spain itself was granted a credit facility to recapitalize Spain's banking sector in order to reactivate the financial system and economy. In exchange for the credit facility, the Financial Assistance Facility Agreement required that the financial institutions develop credible restructuring plans that improve the sector's viability, improve burden sharing, and limit distortions of competition in a manner that promotes financial stability, including reducing the amount of participating entities and regional banks' exposure to non-performing and under-performing real estate related assets. The ESM provided a credit facility of up to \$100 billion Euros to FROB, which acted as guarantor of the facility and was responsible for dispensing the

funds to the respective institutions. Those actions, together with social benefit cuts, public employee salary reductions, tax increases, and social austerity policies, began to bring confidence back to the public.

In August 2012, the Spanish Government established SAREB, or commonly known as the "bad bank," which is beneficially owned by the State, private institutional investors and Spanish banks. SAREB began acquiring bad assets from banks, including non-performing loan portfolios and properties, at a discount, in exchange for bonds secured by the Government of Spain. For example, according to a report released by SAREB in May 2014, SAREB's original portfolio of distressed real estate assets was worth approximately 51 billion Euros, which demonstrated the size and significance of the assets acquired by SAREB.⁴ SAREB's strategy is to hold the assets and dispose of them to the public in an organized manner, operating similar to asset management firms. One of the goals of SAREB was to improve the availability of credit in the system by removing these bad assets from banks' balance sheets and stabilizing prices by controlling the supply of real estate assets entering the market.

Further, in 2012, the Spanish government approved structural changes to the Spanish Real Estate

3 Embassy Madrid. *Spain's Booming Housing Market And The Uncertain Future*. Rep. Embassy Madrid, 18 Mar. 2005. Web. 8 Sept. 2014.

4 SAREB, The Key To Cleaning Up Spanish Banks' Balance Sheet. "SAREB." *Press Kit May 2014* (2014): n. pag. www.sareb.es. SAREB, May 2014. Web. 9 Sept. 2014.

Investment Trust, (SOCIMI – the Spanish REIT regime). These changes made the investment vehicle more attractive, mainly by reducing the taxation rate from 19% to 0%. This Spanish REIT structure brought a competitive investment vehicle with similar characteristics to REIT structures along Europe and the US and provided a way to increase the amount of capital flowing to the real estate sector. Since the changes, more than 20 Spanish REITs have registered with Spanish tax authorities.

These reforms led to an improving economic environment, as discussed further below.

Current environment

The outlook for the Spanish economy is the best it has been since 2008. Analysts expect that GDP will be positive during 2014. The Wall Street Journal notes that during Q3 2014 the unemployment rate fell to approximately 23.7% after peaking at over 27%. Year to date GDP through Q3 2014 is 1.6%, the highest it has been since before 2008, and Spain's borrowing costs are back to pre-crisis levels. Additionally, housing price declines have started to stabilize, as investors step into the market and the availability of credit improves.

The banking industry has also shown evidence of improvement. Although the real estate industry has not yet seen a substantial increase in available financing, with the consolidation of many smaller and weaker financial institutions, which either entered bankruptcy or merged with larger and

more stable institutions, coupled with the reforms discussed above, stronger banks are emerging. According to Bloomberg, after a stress test by the ECB in Q3 2014, Spanish Banks were shown to need no additional capital infusions⁵, evidencing the health of the Spanish banking system.

While the outlook is positive and the economic environment appears to be more stable than it has been during the previous six years, current demographics still cause concerns. Unemployment is still at 23.7%, which will continue to impact the consumers' ability to purchase homes. Moreover, the unemployment rate among the Spanish youth is significantly higher than the overall unemployment rate. Economists expect the high youth unemployment rate to slow the absorption of excess supply in the housing market, which resulted from years of over construction during the boom. There are also questions about whether the economic performance of other European countries will affect the recovery in Spain.

Despite conflicting economic indicators, investors have been deploying capital into Spanish real estate assets over the last couple of years. CBRE Spain reported that approximately \$5 billion worth of real estate transactions took place during 2013 and investors expect a higher volume of transactions during

2014.⁶ According to an October 2014 Cushman and Wakefield report, almost 14 billion euros in transactions have closed during the nine months ended September 2014.⁷

Transactions to date

The Spanish real estate market has been attracting distressed investors since the beginning of 2013. According to DealBook, in July 2013, Blackstone bought 1,860 apartments for 125.5 million euros, followed by Goldman Sachs purchasing a block of public housing in Madrid.⁶ This was followed by SAREB selling a 51% stake in a portfolio of close to 1,000 homes around Spain in August 2013, valued at approximately 100 million euros, to H.I.G. Capital.⁸ Subsequently, in July 2014, Blackstone bought a portfolio of 40,000 mortgage loans for 3.6 billion euros, outbidding other opportunistic investors including Oaktree Capital Management LP and Apollo Global Management.⁹

5 Munoz, Macarena. "Spanish Banks Shown Needing No Capital After ECB Exercise." *Bloomberg.com*. Bloomberg, 26 Oct. 2014. Web. 02 Nov. 2014.

6 Anderson, Jenny. "Global Investors Looking for Real Estate Bargains Flock to Spain." *DealBook.NYTimes.com*. New York Times, 29 May 2014. Web. 09 Sept. 2014.

7 A Cushman & Wakefield Corporate Finance Publication. "European Real Estate Loan Sales Market." *C&W Corporate Finance Publications* (2014): n. pag. *World Property Journal.com*. Cushman and Wakefield, 1 Oct. 2014. Web. 11 Nov. 2014.

8 White, Sarah. "Spain's Bad Bank Close to Big Land Sale as Disposals Pick up." *Reuters*. Thomson Reuters, 04 Oct. 2013. Web. 02 Nov. 2014.

9 Neumann, Jeannette. "Squatters Welcome Blackstone's Spanish Property Play." *The Wall Street Journal*. Dow Jones & Company, 23 Sept. 2014. Web. 02 Nov. 2014.

More recently, major investment firms such as Apollo Global Management and TPG Capital have been bidding on a contract to market and sell around 50 billion euros worth of property assets held by SAREB, with other bidders including Centerbridge Partners LP and Haya Real Estate SA, owned by Cerberus Capital Management LP.¹⁰

Moreover, according to the Wall Street Journal, “Spain has seen the most IPOs in Europe in the recent REIT boom, with five listing this year and more to come.”¹¹ Merlin Properties SOCIMI SA raised 1.25 billion euros and expects to have invested 92% of it by the end of the year. Hispania Activos Inmobiliarios also went public during 2014, with investors including Funds managed by George Soros, John Paulson, Moore Capital Management, and Cohen & Steers.¹² While investors appear to be attracted to the risk reward characteristics of the investment opportunities in Spain, despite indications the Spanish economy is improving, there remains a lot of uncertainty that will impact the ultimate success of investments in Spain.

Summary

Since the recent housing crisis in Spain, regulators and the government have enforced structural changes in the economic environment to support the recovery and maturation process of the real estate markets. Following the creation of SAREB, investors from around the world have increasingly pursued deals to gain exposure to Spanish real estate, which has helped support a price floor. Despite uncertainties in Spain’s economy, including high unemployment, as real estate prices have stabilized, investors have continued to pursue deals in Spain. Overseas investors, interested in distressed assets coming to market, have provided liquidity and changed the landscape of the real estate sector in Spain. The presence of new debt and equity in the market is a sign that investors are cautiously optimistic that the recovery in Spain may continue forward.

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10 Neumann, Jeannette. “Spain’s ‘Bad Bank’ Assets Selloff Goes to Next Round.” *The Wall Street Journal*. Dow Jones & Company, 5 Sept. 2014. Web. 02 Nov. 2014.

11 Pirolo, Alessia. “European REITS Are on a Tear.” *The Wall Street Journal*. Dow Jones & Company, 9 Sept. 2014. Web. 02 Nov. 2014.

12 Rodriguez, Jose. “Spanish property fund attracts Soros, Paulson ahead of share listing.” *Reuters*. Thomson Reuters, 03 Mar. 2014. Web. 19 Nov. 2014.

Emerging Trends in Real Estate 2015: Sustaining momentum but taking nothing for granted

by Andrew Warren

The following is a summary of the results of the 2015 edition of the Emerging Trends in Real Estate. The findings and opinions reflect those of over 1,400 market participants interviewed and/or surveyed and do not necessarily reflect the views of PwC.



Introduction

Real estate market participants continued to express optimism about 2015 in the current edition of Emerging Trends in Real Estate. Interviewees feel that the fundamental improvement experienced in 2014 may continue during 2015 and that this environment should have an impact on the overall real estate market; influencing both investments and operating decisions in the coming year. Survey respondents overwhelmingly view 2015 as a “profitable” year with 74 percent seeing the prospects for profitability being good or better than the previous year. This is up from the 68 percent of respondents who thought that profitability in 2014 would be good or better. The top 10 trends identified in this year’s report, cover a range of themes including: demographics, competition and risk awareness.

Despite a general sense of optimism surrounding the 2015 real estate market, interviewees are taking nothing for granted. Market participants appear to be well aware of a number of risks that could be problematic for the market in 2015. These risks encompass additional

geopolitical events and concern about current real estate pricing reaching “bubble” levels not seen since the previous 2007 peak in the market. Accounting for and mitigating these risks may also influence market decisions in 2015.

Trend themes

Demographics are seen as a key driver of a number of 2015’s trends. Interviewees see the impact on real estate markets of the maturation of the different demographic groups and the sheer size of these age cohorts as having a significant impact on the economy in general and real estate in particular.

The changing age game – According to the US Census Bureau, the baby boomer and millennial generations are the two largest population cohorts in the US and have been influencing the real estate market for years. So what do interviewees see that may be different in 2015? Interviewees see that the market may be driven by the fact that a significant number of these two age groups are reaching ages where they will likely be making significant life style choices; for example, where to live, home purchases, job status and the like. The

real estate market is contemplating the potential impact on housing and commercial real estate markets.

By 2020, census data suggests that there could be nearly 80 million people who are either millennials age 30 or greater and baby boomers between the ages of 55 to 64. There are a number of questions surrounding the life decisions these groups may make in the next five years, all questions that could influence how different physical locations and real estate sectors will perform in the next five years:

- Will they form households?
- Where will they choose to live?
- Will they remain in the labor force?

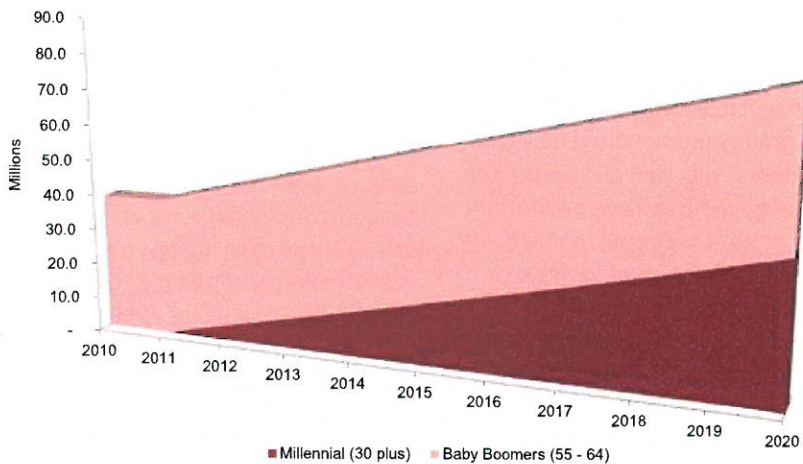
As one interviewee commented, “the biggest risk used to be whether the tenant in a building would renew at the end of their lease term, now you have to be confident that your property will be viable at the end of the term.”

Labor markets trending toward tipping point – Relating to the aging of the population is the future size of the US labor force. Interviewees mentioned labor shortages in a number of areas including construction and building maintenance as being problems in 2014, but also raised the issue of labor shortages occurring across the country in the coming years. The concern is not just about shortages of workers, but will those workers have the skills needed to perform the available jobs.

By 2017, the number of baby boomers turning 65 will begin to outpace the number of Generation Z turning 16 (the Bureau of Labor Statistics defines the labor force as non-institutional population ages 16 – 64). The result would be a stabilized decrease in the size of the labor force of approximately 50,000 a year by 2020.

An impending labor shortage likely won't be uniform across the US. Interviewees continue to show interest in those markets that look better positioned to attract a qualified working age population. These markets offer attractive lifestyle amenities, a lower cost of doing business, a lower cost of living or a combination of all three. The concept of jobs chasing people could have a significant impact on individual real estate markets in the near future.

Figure 1 – Population that will be making lifestyle decisions in the next five years



Source: US Census Bureau

Competition

The positive expectations for 2015 are not going unnoticed and interviewees expect increasing competition to drive a number of trends in the future. Competition for investments is expected to rise as the US real estate market remains an attractive destination for both domestic and international capital. In addition, the potential for new sources of capital to enter the market could only serve to increase the competition for attractive investments. Finally, the increases in the development and adoption of technology is seen as having an impact on virtually all sectors of the real estate market.

Love/hate relationship with technology – Interviewees continue to express amazement at the integration of technology into a growing number of aspects in the economy and the influence technology is having on all real estate sectors. The impact of technology includes the continued adoption that is changing how office space is being utilized, continued growth of e-commerce, and the multiple enhancements that technology is making possible to growth in the sharing economy.

It isn't just the adoption of technology that market participants see changing the market, but also the pace of the adoption. New technology is being adopted at an ever faster pace. The combination of integrated devices and a populous that is accepting of

technological change is helping to speed how fast technology is changing the industry.

Darwinian market keeps squeeze on companies – Technology and competition aren't only impacting investment decisions, but internal company operations as well. The attractiveness of the real estate market is leading participants to continue to look for ways to get bigger and more efficient. Interviewees are expecting to see continued consolidation in the market from service providers to fund managers. The market's desire to get more efficient and operate at lower costs is a driving force behind this trend as well as service providers looking to expand product offerings or expand geographic footprints.

Risk

The 2015 outlook for the real estate market is good, but that doesn't mean the market is ignoring inherent risks.

Event risk is here to stay – Interviewees feel that the biggest risk to the US economy and subsequently the real estate market would be some type of global "black swan" event. The number of geopolitical events that surfaced in 2014 continue to make the US real estate market look like a favorable location to invest if one of your primary investment objectives is return "of" capital. This is expected to keep competition for market defined trophy assets intense for the foreseeable future.

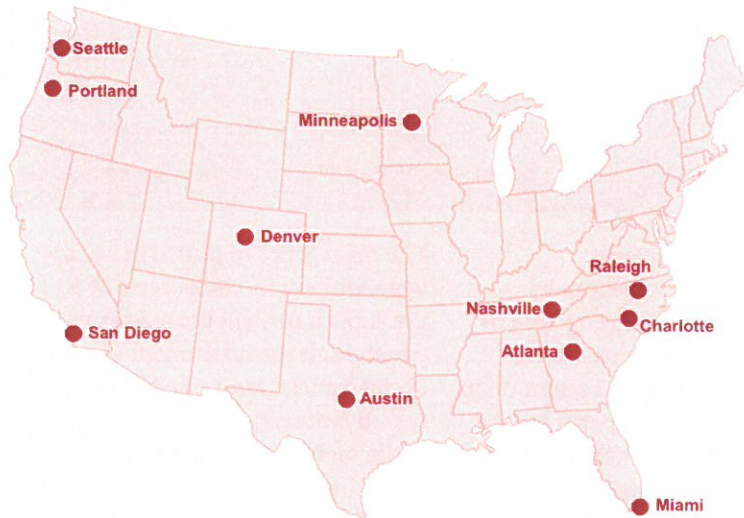
Keeping an eye on the bubble, emerging concerns – While the majority of interviewees don't feel like the overall commercial real estate market is in "bubble" territory, the consensus seems to be that the situation bears watching. Certain product types and markets have seen underlying values bounce back to pre-downturn levels, but values and capital flows to much of the country remain well below previous peak levels.

Market outlook

2015 survey respondents and interviewees expect improvement in most markets for the coming year. Most markets are viewed as benefitting from improved economic growth along with steadily improving fundamentals. The big six markets (New York, Boston, Washington DC, Chicago, Los Angeles and San Francisco) are generally projected to be good performers. The top market trend however, highlights market participants' desire to find opportunities in markets that will benefit from other identified trends.

18-hour city comes of age – Interviewees see 18-hour cities as being strong investment choices in 2015. These cities offer a number of the advantages of the big six markets; urban lifestyle choices, well-educated workforces, diverse employment choices, but they tend to offer these amenities at a more attractive price point.

Figure 2 – Top 18-hour cities



Source: Emerging Trends in Real Estate 2015

These markets are proving to be attractive to millennials entering the workforce so they have the potential to attract skilled labor to their urban core. As the millennials get older they may also find these markets more attractive due to the lower cost of living that offers a better chance of owning a home. 18-hour cities that survey respondents put in the top 10 markets for 2015 are: Austin, Denver, Charlotte, Seattle and Raleigh.

The attractiveness of these markets to potential labor along with what is typically a lower cost of doing business could make these markets attractive to businesses looking to relocate or expand their operations. While these markets are ranked by this year's survey as attractive, they are not without risk. A number of them are not considered supply constrained markets so the potential for oversupply does

exist. Despite this risk, the outlook is that they will continue to offer good investment potential over the next several years.

Conclusion

The general consensus of interviewees and survey respondents is that the outlook for commercial real estate in 2015 is positive as market fundamentals continue to improve. The general outlook for a number of markets and property types has improved and the opportunity for investments in more locations and utilizing different strategies should increase. Despite the overall positive outlook, market participants continue to be monitoring a number of demographic, competitive and risk trends to choose where the best opportunities will be in the coming year.

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The resurgence of the mortgage REIT

*by Lynn Chin, Dan Sullivan,
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Over the past several years, mortgage real estate investment trusts (M-REITs) have re-emerged as popular investment vehicles in the marketplace and attracted attention in the media. The major impetus for the resurgence of M-REITs has been a low interest rate environment. M-REITs can offer investors attractive yields by investing in higher yielding assets and implementing the right leverage.

Changes in the rules related to classification of investment companies have resulted in a greater number of market participants utilizing an M-REIT structure. M-REITs are generally not characterized as an Investment Company. This non-Investment Company characterization is primarily due to the involvement in “purchasing or otherwise acquiring mortgages and other liens on and interests in real estate” (15 U.S.C. § 80a-3(c)(5)(C)). This exemption allows M-REITs more flexibility with the use of leverage and the ability to operate with less rigorous regulatory oversight while meeting the strict provisions set out in the Internal Revenue Code (“IRC”) to maintain REIT status.

The resurgence of M-REITs has not been without its challenges. M-REITs are subject to complicated tax rules which limit the investment activities of the vehicle. Maintaining the tax-advantaged status of the M-REIT while managing its operational risks is an ongoing challenge. M-REIT managers must successfully employ a strategy that requires deep understanding of the complex tax, regulatory and US GAAP rules and the interactions between them to create a streamlined operation that ensures ongoing compliance with these rules. The penalties of non-compliance are severe and can significantly impact an M-REIT’s tax status and its appeal to investors.

Why are M-REITs attractive to investors?

M-REITs effectively operate as a pass-through entity where the M-REIT manager (“operator”) distributes its income to investors which is then taxed as a dividend, thereby eliminating any corporate taxes. M-REITs use committed capital and employ a leverage strategy on their assets, commonly through repo

funding to purchase longer-term assets. This strategy in a low interest rate environment can increase revenues and dividend yield to investors.

M-REITs are being used as a funding source for a wider range of assets. M-REITs have generally invested in agency and private label residential mortgage backed securities (MBS), but are now expanding their portfolios into other asset classes such as excess mortgage servicing rights (excess MSRs) and residential whole loans. Utilizing a private letter ruling from the IRS, market participants are interpreting the margin between the loan servicing fee and the cost to service each loan (subject to certain thresholds) as a qualifying asset.¹

Unlike earlier structures, newer M-REITs are taking advantage of the US housing recovery in loans and securities. M-REITs are accumulating portfolios of loans and, in some cases, monetizing portions of those loans through securitization.

How do the tax rules drive M-REIT activity?

In order to maintain its status and avoid double taxation, M-REITs must follow the IRC's gross income and asset tests and other regulatory requirements. If M-REITs engage in certain impermissible activities, the income generated may be subject to a 100% prohibited transactions tax. For example, a re-securitization

transaction that is treated as a tax sale could be deemed dealer activity and considered a prohibited transaction subject to 100% tax. As such, M-REIT operators must ensure that they align their activities with the appropriate tax structures entities to promote tax efficiency.

Most M-REITs utilize efficient tax structures and a robust infrastructure to support these operations. Specialists can assist in evaluating standards and the ongoing tax compliance and reporting calculations incidental to operating any M-REIT. These include certain tax hedge identification requirements, the aforementioned quarterly asset and annual income tests, certain elections with implications to shareholder distributions and M-REIT taxable income.

Operational complexities of new M-REITs strategies

M-REITs investing outside of the agency MBS space commonly have higher data needs. As M-REITs enter into new strategies, including originating and securitizing mortgages, the technology and data required to store and process that data increases significantly. The potential operational hurdles can be quite burdensome and may lead to a re-evaluation of the impact on their existing tax, accounting and operational frameworks.

M-REITs require incremental infrastructure for capturing, monitoring and using data to meet valuation, tax, regulatory and financial

reporting needs. The origination and securitization of mortgages for an M-REIT strategy are two primary examples where M-REIT operators are leveraging technology and infrastructure support in order to operate data-intensive businesses while considering all the complexities inherent within the M-REIT.

US GAAP accounting considerations

While REITs are tax driven vehicles, there are numerous US GAAP financial reporting complexities that M-REITs face. As M-REITs expand their activities, their financial statement presentation may incorporate issues historically encountered by originators and securitizers, as opposed to just investors.

In particular, M-REITs are likely to face challenges related to:

- Determining which legal entities will be consolidated into its financial statements based on the M-REIT's legal structure and investment profile;
- The recognition or de-recognition of assets or liabilities from its balance sheet;
- The usage of derivatives for hedging purposes and the associated accounting and valuation for those derivatives;
- The financing strategy and the amount of leverage that a M-REIT employs;

¹ PLR 201234006

- Complex accounting issues regarding accounting for investments and certain liabilities, such as embedded derivative analysis, interest income approaches and other-than temporary impairment (“OTTI”) evaluation; and
- Extensive disclosure regarding their assets and liabilities, including valuation and accounting policies.

Many M-REITs choose to simplify some accounting complexities by making an irrevocable election, upon acquisition or origination of financial assets or liabilities, to classify and measure instruments at fair value. As a result, all changes in fair value of that instrument will be recorded in net income. This election can cause volatility in earnings, but assists in avoiding the complexity within other areas of US GAAP, such performing embedded derivative analysis.

The PwC Financial Instruments, Structured Products, and Real Estate (FSR) group helps clients achieve success in the capital markets. FSR’s deep product knowledge and industry insight can assist companies wishing to become a leader in the M-REIT marketplace by offering tax, accounting and finance solutions to navigate the changing M-REIT landscape.

Summary

In addition to creating a compelling investment strategy, M-REITs are seeking to increase value through focusing on expanding their eligible asset investment profile, implementing appropriate tax strategies for the broader investment profile, and creating an efficient infrastructure to support operations. Rapid improvements in technology are enabling more efficient processing, wider business activities, and more sophisticated analysis. A full understanding of the rules and appropriate planning should be taken for any market participant seeking to enter to the M-REIT marketplace.

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Searching for higher-yielding CRE investments

by Susan Smith

The following is extracted from the Fourth Quarter 2014 issue of the PwC Real Estate Investor Survey, released on December 15, 2014. The findings and opinions reflect those of the investors surveyed and do not necessarily reflect the views of PwC.



As buyers of core assets in major cities face rising prices and declining overall capitalization (cap) rates, a growing number of them are looking for plays outside of core assets and primary markets in search of opportunities to take on greater risk in exchange for higher yield. The aspiration to seek out higher-yielding investments and take on greater risk at this point in the commercial real estate (CRE) cycle reflects investors' confidence in the future performance of both the CRE industry and the US economy. In *Emerging Trends in Real Estate® 2015*, recently published by PwC and ULI, value-added, development, and opportunistic investments are considered to have the best prospects for returns in 2015 – ahead of core-plus and core investments, according to *Emerging Trends* respondents.

While certain investors are moving further out on the risk spectrum, it is not yet a uniform strategy, particularly for some conservative institutional players, like pension funds, which continue to prefer the elements of “core” investing – Class-A properties, gateway markets, steady income streams with staggered lease expirations – given the need for adequate returns and conserving the capital entrusted to them as fiduciaries. As it becomes much harder to find core deals that make sense and

face the continual challenge of putting accumulating capital to work meeting long-term liabilities, some are “going where they have never gone before,” heading for niche property types and secondary markets.

Niche property types, like self storage, medical office, and student housing, continue to grow in popularity among both domestic and international buyers. While many players in these niche sectors were first drawn to them at the peak of the previous cycle as pricing for traditional assets got ahead of market fundamentals, they have stayed because of positive demographic trends and favorable risk-adjusted returns.

The search for higher yield in secondary markets is evident when looking at recent sales data. For the 12 months ended June 2014, investing in secondary markets was up nearly 25.0% and back to nearly 72.0% of the previous peak level, as per Real Capital Analytics. With global capital looking to move outside of its typical comfort zone, which has been core major markets and assets, and more investors willing to go where they see the best opportunities, both niche property sectors and secondary markets could report strong investment activity in 2015.

Tenant improvement (TI) allowances

TI allowances vary for each major property sector, as well as across geographies. Based on our Survey, TIs are rarely provided to tenants in regional malls and power centers, where retail tenants typically receive space as a “vanilla box” and are responsible for their own build-out. In industrial and office properties, TIs are commonplace and vary based on whether the leased area is shell space (raw, new space) or existing, second-generation space.

For the 19 city-specific office markets in the Survey, TI allowances for shell space range up to \$125.00 per square foot and average \$50.04 per square foot. For second-generation office space, TI allowances range up to \$100.00 per square foot and average \$29.07 per square foot. For renewals, TIs range up to \$100.00 per square foot and average \$17.32 per square foot.

For the Survey’s warehouse markets, TI allowances for shell space range up to \$75.00 per square foot and average \$4.21 per square foot. For second-generation space, TI allowances range up to \$5.00 per square foot and average \$1.29 per square foot. For renewals, TIs range up to \$3.00 per square foot and average \$0.77 per square foot. For the national warehouse market, up to 20.0% of the leased area is finished office space with an average amount of 8.6%.

Overall cap rates

Fervent competition for a limited pool of quality offerings, still-low interest rates, and an abundance of debt and equity pursuing commercial real estate continue to compress yields for the best properties and the best locations across each major property sector.

This quarter, the aggregate average overall cap rate dips for the Survey’s 34 markets (excluding development land) for the eighteenth straight quarter and at 6.52% stands as the lowest aggregate average since 1997.

Cap rate declines are diverse and spread across property sectors and locations with the national regional mall and medical office buildings markets each reporting sizeable quarterly drops along with a few city-specific office markets, like Houston. In contrast, the average overall cap rate holds steady for the national strip shopping center and national CBD office markets, which up until now have mainly been reporting declines.

Overall cap rate compression also continues for the national warehouse market, as well as the Pacific and East North Central region warehouse markets.

CRE sector overviews

Office

The national office market sits solidly in the recovery phase of the real estate cycle as fundamentals improve for

both CBD and suburban subsectors. Nationally, additions to supply are expected to trail demand, and the US vacancy rate is forecast to slowly improve as the sector moves into expansion in 2016.

Survey participants describe the buying environment in the national CBD office market as “competitive” and “crowded” as investors vie to capitalize on the office sector’s ongoing recovery highlighted by growing absorption levels and limited additions to supply. Over the next 12 months, our Survey results show investors expecting property values in the national CBD office market to increase as much as 15.0% with an average expected value increase of 4.9%.

For the national suburban office market, surveyed investors remain upbeat about its future performance. “Many markets are recovering and providing upside so it’s a good time to own suburban office,” states one surveyed investor. Suburban office properties for sale on the West Coast, such as in Los Angeles, San Diego, and San Jose, continue to draw significant attention from buyers. Furthermore, Southern and Southwest cities, like Dallas, Phoenix, and Denver, are seeing numerous suburban office assets trade.

Retail

As national retail fundamentals continue to slowly improve, the sector is expected to remain in the recession phase of the real estate cycle before transitioning into recovery by year-end

2015. However, a number of individual markets, like Austin, Houston, and San Antonio, are currently in expansion, buoyed by solid demographic and economic trends.

Despite rising consumer confidence and growing retail sales figures, the still-changing retail landscape continues to suppress demand for physical store space among many retailers. From an investment standpoint, the slow and inconsistent recovery in the retail sector continues to favor high-quality regional mall assets, well-located grocery-anchored shopping centers, and well-leased power centers.

Within the retail sector, most surveyed investors foresee positive trends for the US neighborhood and community shopping center sector. While such expectations open up opportunities for both buyers and sellers, most respondents in *Emerging Trends in Real Estate* give this property category a much higher buy than sell recommendation.

Industrial

Steady demand for industrial space is driving new supply in this sector with new additions to supply in 2014 expected to reach the highest level seen since 2008. Fortunately, tenant demand is expected to outpace supply,

keeping the national industrial sector solidly in the recovery phase of the real estate cycle through 2017.

Warehouse industrial ranks as the top pick among investors with regard to investment prospects in the year ahead, as per *Emerging Trends in Real Estate*. Specifically, it scored a 3.72 on a scale of 1 (abysmal) to 5 (excellent), just above CBD office buildings with a score of 3.57 and limited-service hotels with a score of 3.52.

For the flex/R&D segment, certain investors suspect that 2015 could be a good year as rising occupancy levels in suburban office locations spillover into flex/R&D properties, resulting in higher tenant demand, rental rates, and property values. Looking ahead, future rent growth is expected as several surveyed investors are using rent spikes in their cash flow analyses.

Apartment

The national multifamily market remains in the expansion phase of the real estate cycle through the end of 2014, but will likely shift into the contraction phase in 2015 as new apartment supply outpaces demand in many metros, limiting rent growth opportunities during the initial lease-up periods. Major metros currently at the peak of the

expansion phase include Charlotte, Chicago, Dallas, Denver, Houston, and Seattle. In 2015 through 2017, the apartment sectors within many cities will move into the contraction phase of the cycle as they work to absorb new construction.

Despite the characterization by certain investors of a “too pricey” and “crowded” apartment market, this asset class placed second again this year for overall investment prospects in *Emerging Trends in Real Estate*, scoring a 3.48 on a scale of 1 (abysmal) to 5 (excellent), compared to a score of 3.61 for the industrial/distribution market.

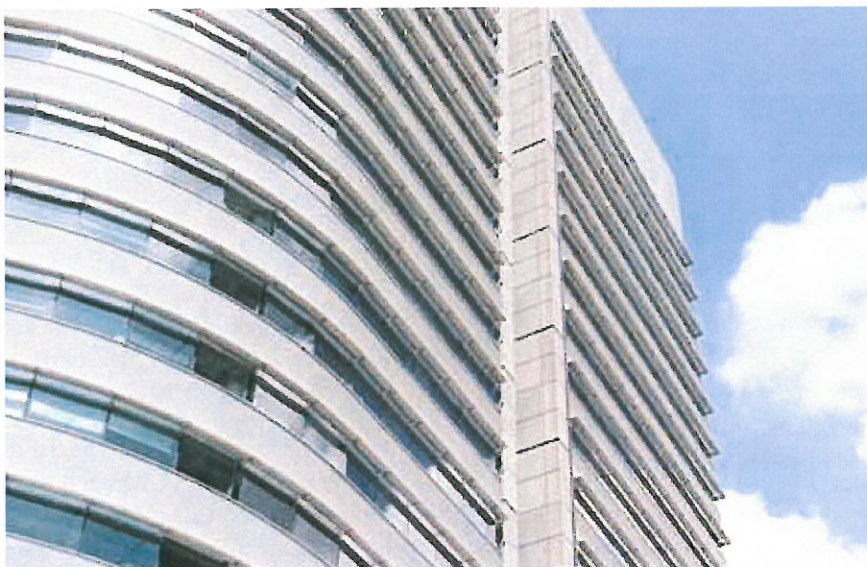
Along with vigorous sales velocity, this market’s average overall cap rate dropped to its lowest point in the Survey since its debut in mid-1990. As shown in Table 29, the average overall cap rate drops 15 basis points this quarter to 5.36%. “Cap rates have compressed in both value-added and core deals,” remarks a surveyed investor. In the next six months as the supply and demand dynamics shift due to increases in new development, surveyed investors foresee overall cap rates holding steady in this market.

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More information on the PwC Real Estate Investor Survey™ can be found at www.pwc.com/us/realestatesurvey or by calling 1-800-654-3387.

SEC comment letter trends for real estate companies

by Paul Kolodziej



The Securities and Exchange Commission (“SEC”) continues to emphasize the importance of providing meaningful and transparent information to investors and recently highlighted this during the 2014 AICPA National Conference on Current SEC and PCAOB Developments. Understanding the SEC Staff’s recent areas of focus is an important aspect to consider as part of the upcoming year-end reporting process. To help registrants gain insight into the SEC staff’s current areas of focus, PwC analyzed comment letters issued to real estate companies during the last year to identify trends. The trends identified are somewhat consistent with those in other industries, including management’s discussion and analysis and results of operations disclosures being the most prevalent.

The four areas that received the most comments for real estate companies were leasing activities, same property comparison, cost capitalization, and consolidation. Below is further detail on the SEC comment letters received over each of these areas.

Leasing activities

The most frequent area of comment by the SEC was over management’s discussion and analysis, with leasing activities being a primary focus. Specifically, the SEC staff has requested enhanced discussion of trends in leasing activities for real estate investment trusts (REITs), including disclosure of average occupancy, average rental rates, comparison of rates of expiring leases vs. current market rents, and costs incurred to obtain new leases.

Same property comparison

The SEC staff continues to provide comments on the registrants’ explanation of their results of operations, with a focus on same property performance. The SEC staff’s comments in this area have focused on providing greater transparency into which properties are included in a registrants’ same property portfolio. Specifically, the staff has requested clear disclosure of when development and redevelopment properties are transferred into and out of the same property portfolio and whether acquisitions/dispositions are included. Additionally, the SEC staff has requested enhanced disclosure

of the period over period operating performance of the same property portfolio, including the impact of occupancy changes and rental rate changes.

The SEC staff's comments have also focused on registrants providing enhanced disclosure around same property net operating income (NOI). Specifically, the SEC staff has requested that registrants disclose whether management considers same property NOI a key performance measure, define which properties are included in the same property portfolio, include a clear definition of how same property NOI is computed and a reconciliation to the most directly comparable GAAP measure.

Cost capitalization

Recent comment letter trends show that cost capitalization continues to be an area of focus. The SEC staff has asked for disclosure of total soft costs (e.g., interest expense, real estate taxes, payroll, and other general and administrative expenses) capitalized during each period presented. Additionally, the SEC staff has requested further breakout of soft costs capitalized by development, redevelopment, and other capitalized expenditures within MD&A, along with a narrative discussion of fluctuations

from year to year. Further, the SEC staff has also requested that registrants disclose in MD&A the anticipated completion date, budgeted costs and costs incurred to date for significant development projects.

The SEC staff has also requested that registrants define when the capitalization period for development begins and ends in their accounting policy footnote and present cash flows used to acquire real estate separate from development costs within the statement of cash flows.

Consolidation

Consolidation continues to be an area of focus for the SEC staff. The SEC staff comments have requested that registrants enhance their disclosures of their accounting policy and the determination of which entities are consolidated and which ones are not. Specifically, the SEC staff has focused on investments in which the registrant owns a greater than 50% interest, but accounts for such investment under the equity method of accounting. Registrants should ensure they clearly disclose the provisions of such governing agreement that led the registrant to determine that consolidation was not necessary.

In addition, the SEC staff has requested additional information about registrant's primary beneficiary assessment, focusing on the significant judgments and assumptions, the qualitative factors considered, and the quantitative analysis used, if any, to determine whether the rights to receive benefits could potentially be significant. The SEC staff has also focused on the existence of any control deficiencies relating to a company's consolidation policy and how management determined the severity of the deficiency.

Conclusion

The uncertainties in the current economic and regulatory environment make the preparation of high-quality reports increasingly important and challenging. The SEC Staff continues to emphasize the importance of providing information to investors that is reliable, meaningful and transparent, particularly in areas that involve significant judgement. With a better understanding of the SEC staff's latest areas of focus, companies will be able to better produce high-quality annual reports for investors and other stakeholders.

For further details on SEC Comment Letter Trends for Real Estate Companies see the Stay informed, 2014 SEC comment letter trends, Financial Services publication at the link below.

<http://www.pwc.com/us/en/cfodirect/publications/sec-comment-letter-trends/financial-services.jhtml>

For further details on the 2014 AICPA National Conference on Current SEC and PCAOB Developments see the In depth linked below.

http://www.pwc.com/en_US/us/cfodirect/assets/pdf/in-depth/us2014-09-aicpa-conference.pdf

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Real estate state and local taxation: Industry update

by Sean R. Kanousis,
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New York State Tax Reform

On March 31, 2014, New York State enacted legislation that overhauled the state's corporate tax regime as well as makes other significant tax changes. This new legislation is effective for tax years beginning on or after January 1, 2015. In particular, this new legislation replaces the state's existing combined reporting provisions which required the existence of substantial intercorporate transactions between related corporations with a waters-edge unitary combined reporting system.¹

This new legislation will require two or more corporations engaged in a unitary business to file a combined report when at least one of the following requirements is met: (1) the taxpayer owns or controls either directly or indirectly more than 50 percent of the voting power of the capital stock of another corporation; (2) one or more corporations own

or control more than 50 percent of the voting power of the capital stock of the taxpayer either directly or indirectly; or (3) more than 50 percent of the voting power of the capital stock of the taxpayer and such other corporations is owned or controlled directly or indirectly by the same interests.² Further, an alien corporation is now required to be included in a combined report if it satisfies these general combined filing requirements unless it is not classified as a "domestic corporation" pursuant to IRC section 7701 and it has no effectively connected income with the United States as determined under IRC section 882.³

The definition of a captive real estate investment trust ("REIT") has remained unchanged in the updated New York State Tax Law.⁴ Non-captive REITs are now statutorily exempt from combined reporting under the new combined filing regime.⁵ On the other hand, captive REITs are

1 NY Tax Law § 211(4)(a).

2 NY Tax Law § 210-C(2)(a).

3 NY Tax Law § 210-C(2)(b)(iii); NY Tax Law § 210-C(2)(c)(iv).

4 NY Tax Law § 2(9).

5 NY Tax Law § 210-C(2)(c)(ii).

6 NY Tax Law § 210-C(2)(a); NY Tax Law § 210-C(2)(c)(ii).

still subject to combined reporting requirements.⁶ The new combined filing regime simply requires captive REITs to be included in a combined report with any corporation when the aforementioned updated combined filing standards are met.⁷ Accordingly captive REITs should take care to understand the impact of the tax reform on their New York state filings. Captive REITs that previously filed separately because they did not engage in a substantial intercorporate transaction with a related corporation should analyze their relationships with any taxable REIT subsidiaries or other related corporations to determine whether a combined report is now required.

Whenever a captive REIT is included in a combined report, the updated New York State Tax Code disallows the deduction for any dividends paid to any members of their affiliated group.⁸ Business income, including income resulting from the disallowance of the deduction for dividends paid, will be taxed at the general business taxpayer rate of 7.1 percent in 2015 and then 6.5 percent in all subsequent tax years.⁹ In addition, unlike non-captive REITs, the capital attributable to the captive REIT will still be included in the capital tax base for the combined group, thus resulting in the captive REIT effectively

being subject to the capital tax if the tax calculated using the capital base for the combined group is greater than tax calculated using either the business income base or the fixed dollar minimum base.¹⁰ It must be noted that the effects of this will be mitigated by the fact that the capital tax rate will fall each year during the six-year phased out period beginning on January 1, 2016.¹¹

Tennessee Disregarded Entity Clarification

In June 2014, the Tennessee Department of Revenue issued Notice 14-12 reversing its prior stance on the taxation of federally disregarded single member limited liability companies (“SMLLCs”) that are wholly owned by REITs.¹² In Tennessee, an entity that is disregarded for federal tax purposes can still be treated as a regarded entity with a separate filing obligation.¹³ A SMLLC is only disregarded for Tennessee franchise and excise tax purposes if: (1) it is a disregarded entity for federal tax purposes; and (2) its sole owner is treated as a corporation for federal tax purposes.¹⁴ Despite this rule, the Tennessee Department of Revenue previously had consistently taken the position that a SMLLC owned by a REIT could never be disregarded for Tennessee

tax purposes regardless of whether the REIT was treated as a corporation for federal tax purposes.¹⁵ This resulted in SMLLCs wholly owned by REITs being treated as separate taxpayers for Tennessee franchise and excise (income) tax purposes and potentially subjecting them to an income tax liability.¹⁶

While Tennessee considered the SMLLC of a REIT a separate taxpayer for Tennessee franchise and excise purposes, it was previously unclear whether the SMLLC could benefit from the deduction for dividends paid entitled to its REIT member pursuant to section 857 of the Internal Revenue Code (“dividends paid deduction”).¹⁷ Ruling 13-22 states that the federal taxable income of an entity treated as a disregarded entity for federal tax purposes but regarded as a separate taxpayer in Tennessee would be determined on a pro forma basis as if the disregarded entity had filed as a regarded corporation for federal income tax purposes.¹⁸ Tennessee has held that since disregarded entities do not qualify as REITs for federal income tax purposes, such entities must calculate federal taxable income on a pro forma basis without utilizing the dividends paid deduction.¹⁹ This calculation can result in federally disregarded entities having taxable

7 NY Tax Law § 210-C(2)(b)(i).

8 NY Tax Law § 210-C(4)(f)(i).

9 NY Tax Law § 210(1)(a).

10 NY Tax Law § 210-C(1)(ii).

11 NY Tax Law § 210(1)(b).

12, 20 Tennessee Notice 14-12 (June 2014).

13 Tenn. Code Ann. § 67-4-2106(c).

14, 16 Id.

15, 18 Tennessee Revenue Ruling 13-22 (Dec. 2013).

17 IRC § 857(a).

19 IRC § 856(a).

income in Tennessee even though that income is not taxed at the federal level thanks to that income having been recognized at the REIT level and then offset by the dividends paid deduction.

Notice 14-12 reversed Tennessee's stance as it relates to a federally disregarded SMLLCs whose single member is a REIT.²⁰ Now a SMLLC that is wholly owned by a REIT has no separate Tennessee filing requirement and instead the REIT will file a Tennessee franchise and excise tax return. While a SMLLC filing on a separate company basis may have previously reported an excise tax liability, a REIT should be able to benefit from the dividends paid deduction when calculating its excise tax so long as the REIT is itself not a "captive REIT" for Tennessee purposes.

However, notice 14-12 only extends Tennessee disregarded entity status to SMLLCs owned by REITs.²¹ Revenue Ruling 13-22 explicitly states that other non-SMLLC DREs owned by REITs such as qualified REIT subsidiaries and federally disregarded limited partnerships will still be treated as regarded entities and thus separate taxpayers for Tennessee franchise and excise tax purposes.²² Notice 14-12 has not changed this stance as only the filing position of a federally disregarded SMLLC was addressed in

this notice.²³ Given the recent guidance provided by the state, care should be taken to analyze the impact on the Tennessee tax filing requirements of REIT structures owning real property in the state.

Pennsylvania Local Business Privilege Tax

Localities in Pennsylvania (other than Philadelphia) are delegated the authority to impose a tax on the "privilege of doing business" in their respective jurisdictions under the Local Tax Enabling Act ("LTEA").²⁴ While the LTEA lists a broad base of activities and transactions that can be subjected to this privilege tax, taxation of a number of activities including "leases or lease transactions" is specifically prohibited.²⁵ Despite this prohibition, the Township of Lower Merion, among other localities, had imposed business privilege taxes "at the rate of 1.5 mills" (0.15 percent) on the gross receipts of lessors who lease real property within the township.²⁶

Three taxpayers filed suit in the Court of Common Pleas of Montgomery County arguing that the local business privilege tax imposed by the Township of Lower Merion could not be applied to gross receipts received from lease transactions because the LTEA specifically prohibited it.²⁷

On September 24, 2013, the Court of Common Pleas ruled against the taxpayers stating that the prohibition on imposing a business privilege tax on "leases or lease transactions" found in the LTEA does not prohibit imposing a business privilege tax to the gross receipts from lease transactions.²⁸

The taxpayers appealed the decision of the Court of Common Pleas to the Commonwealth Court of Pennsylvania.²⁹ The taxpayers cited the LTEA's exemption for lease transactions when arguing that their rental receipts should be exempt from the business privilege tax.³⁰ On the other hand, the Township of Lower Merion argued that renting real estate constitutes a "business, trade, occupation or profession in the Township" per the Township's Municipal code and thus is subject to the local business privilege tax.³¹ On September 19, 2014, the Commonwealth Court reversed the lower court's decision holding that the LTEA prohibits subjecting lease transactions to the local business privilege taxes authorized by that statute.³² The Court stated that the exemption against taxing lease transactions prohibits both direct and indirect taxes from being imposed on such lease transactions.³³

21, 28-33 Id.

22 Tennessee Revenue Ruling 13-22 (Dec. 2013).

23 Tenn. Code Ann. § 67-4-2106(c).

24 Pa. Stat. Ann. § 6924.301.1(a.1).

25 Pa. Stat. Ann. § 6924.301.1(f).

26 Township of Lower Merion, Pennsylvania, Municipal Code § 138-42.

27 *Fish v. Twp. of Lower Merion*, No. 1940 C.D. 2013, (Pa. Commw. Ct. 2014).

This decision prevents the future taxation of gross receipts of lessors who lease real property within local jurisdictions in Pennsylvania (other than Philadelphia). This ruling also allows taxpayer to claim refunds for taxes paid on rental real estate receipts for any returns still within the statute of limitations. It must be noted that the Township of Lower Merion could still appeal this decision to the Pennsylvania Supreme Court.

California Proposition 13 Update

In 1978, voters in California adopted Proposition 13 in order to limit property reassessment and taxation. Following this constitutional amendment, yearly reassessment of any property going forward could not exceed 2 percent unless a “change in ownership” occurs. When a change in ownership occurs with regards to a property, the state can fully reassess that property. Generally a transfer of the ownership interest in a legal entity does not constitute a change in ownership with regards to the real property owned by that legal entity.³⁴ However, a change in ownership in the underlying real property of an entity does occur when any one person or entity obtains control of more than 50 percent of the ownership interest in that entity.³⁵

In 2006, 100 percent of the ownership interest of Ocean Avenue LLC (“Ocean”) was transferred.³⁶ Ocean owned a hotel located in California. Michael Dell indirectly acquired approximately 48 percent of the ownership interest of Ocean meanwhile his wife acquired 49 percent of Ocean through a separate property trust.³⁷ The Los Angeles County Assessor deemed a change in ownership to have occurred and reassessed the hotel despite no one person having acquired a greater than 50 percent interest. Upon appeal by Ocean, the Los Angeles County Assessment Appeals Board upheld the reassessment citing several arguments the most notable of which was that reassessment was appropriate because all of the beneficial ownership rights in the hotel had been transferred.³⁸ Ocean subsequently filed a refund claim arguing that the hotel could not be reassessed because there was no change in ownership in the ownership interest of Ocean for Proposition 13 purposes.³⁹ The trial court entered judgment in favor of Ocean.⁴⁰

On appeal, the California Court of Appeals upheld the lower court’s ruling on June 24, 2014.⁴¹ The Court rejected the Los Angeles Assessor’s argument that substance should take precedence over form.⁴² The Court found that the

plain statutory language defining a change in ownership was unambiguous and when applied to these facts no change in ownership had occurred with regards to the hotel.⁴³ Thus, the Los Angeles Assessor was barred from reassessing the hotel. This ruling affirms that prior tax positions taken based on the plain statutory language defining a change in ownership are valid. Further, this ruling indicates that county assessors will follow this interpretation of what constitutes a change in ownership going forward.

California Documentary Transfer Tax Update

In California, documentary transfer taxes have generally been imposed at the local level only when a direct interest in realty is sold.⁴⁴ The majority of localities had not previously attempted to impose a documentary transfer tax following a change in ownership for Proposition 13 purposes. Accordingly, the sale or transfer of an entity who indirectly holds real property in the state has not historically been subjected to the documentary transfer tax. However, the Los Angeles County Assessor has been asserting that a documentary transfer tax liability is created under existing law whenever a change in ownership occurs since 2010.^{45,46} In

34 Cal. Rev. & Tax Code § 64(a).

35 Cal. Rev. & Tax Code § 64(c)(1).

36 *Ocean Avenue LLC v. County of Los Angeles*, B246499.

37-43, 47-48 *Id.*

44 Cal. Rev. & Tax Code § 11911(a).

45 Los Angeles County Code § 4.60.020.

46 *926 North Ardmore Avenue, LLC v. County of Los Angeles*, 178 Cal.Rptr.3d 78 (2014).

one such instance, the Los Angeles County Assessor attempted to collect a documentary transfer tax from 926 North Ardmore LLC (“Ardmore”) with regards to a series of transfers of the ownership interests in its sole owner that resulted in an undisputed change in ownership for Proposition 13 purposes.⁴⁷ Ardmore paid the documentary transfer tax bill but then filed a claim with the county for a refund of the taxes paid.⁴⁸

After the county rejected this refund claim, Ardmore filed a complaint seeking a tax refund asserting that the Los Angeles County Assessor had an illegal policy of imposing a documentary transfer tax on the transfers of interest in legal entities that directly or indirectly hold real property in the county.⁴⁹ The trial court ruled in favor of the county holding that the Los Angeles County

Assessor has the authority to impose a documentary transfer tax on the transfer of an interest in a legal entity when it constitutes a change in ownership for Proposition 13 purposes.⁵⁰

On September 22, 2014, the Court of Appeals upheld the lower court’s decision stating that whenever a change in ownership occurs for Proposition 13 purposes, it constitutes “realty sold” for California documentary transfer tax purposes thus equating the two terms.⁵¹ While the Court admits that section 11911 of the California Revenue and Tax Code refers to the sale of the real property as the trigger for the documentary transfer tax, it held that the legislative history supports a reading of section 11911 to apply the tax whenever there is a transfer of indirect ownership of real property.⁵² As a result of the

holding in *926 North Ardmore Avenue, LLC v. County of Los Angeles*, all local jurisdictions in California are now authorized to levy a documentary transfer tax whenever there is a change in ownership for Proposition 13 purposes pursuant to their existing documentary transfer tax ordinances. Further, since this holding interprets existing law, the local counties are not precluded from attempting to collect documentary transfer taxes on previous transactions that resulted in a change in ownership for Proposition 13 purposes. However, it must be noted that Ardmore is currently appealing this decision to the California Supreme Court. Further, the California Taxpayers Association has filed a request for depublication, which if granted, would strip the case of any precedential value.

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49-50 Id.

51 Id.; Cal. Rev. & Tax Code § 11911(a).

52 926 North Ardmore Avenue, LLC v. County of Los Angeles, 178 Cal.Rptr.3d 78 (2014).

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