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REAL ESTATE MONITOR

SUBPRIME HOME LOANS – A NEW CHAPTER

By Robert Klein, Tax Partner

Wells Fargo, the largest U.S. mortgage lender, is slowly getting back into making subprime home loans. The bank is looking for opportunities to increase revenue, as overall mortgage lending volume declines. It believes it has dealt with its prior mortgage problems, particularly with U.S. home loan agencies, to be able to extend credit to borrowers who may have a higher risk profile. These steps by the bank could amount to a substantial change for the subprime mortgage market that brought the banking system to the brink of collapse. Since the recent financial crisis, banks have been reluctant to lend mortgage money to borrowers, except to those deemed to be the safest.

Any loosening of lending standards could boost housing demand from individuals who have been forced to sit out the recent recovery. However, there is the fear that U.S. lenders will, once again, make the same credit errors that contributed to the financial crisis.

Thus far, few other large banks seem ready to follow Wells Fargo's approach, but some smaller companies, not in the banking system, such as Citadel Servicing Corp., are already increasing their subprime lending. To avoid the association with the past, lenders are calling the loans "alternative mortgages" or "alternative mortgage programs" instead of "subprime."

STRICTER LOANS

Wells Fargo is seeking customers who can meet strict criteria, such as showing the ability to repay the loan and having a documented

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CONTENTS

▶CONTINUED FROM PAGE 1

SUBPRIME HOME LOANS

explanation for why a credit score is subprime. It looks for borrowers with credit scores as low as six hundred compared to the prior limit of 640, which often was seen as the cutoff point between prime and subprime borrowers. (Credit scores range from 300 to 850). As a result of financial reform, lenders remain cautious. Under the Dodd-Frank law, borrowers must meet eight criteria, including income tests and low amounts of other debt. If a borrower fails to meet those conditions, and later defaults on a mortgage, the borrower can sue the lender and argue the loan should not have been granted in the first place.

▶BUILDING A WALL

The rules have helped create a wall between prime and subprime borrowers. Lenders have been avoiding those with credit problems and lower scores and, instead, have been catering to those legally easier to serve. Lenders have reasons to try to reach further down the credit scale now. Rising mortgage rates since mid-2013 are expected to reduce total U.S. mortgage lending in 2014 by more than 36 percent, primarily due to a large drop in refinancing, according to forecasts by the Mortgage Bankers Association. A recent report by the Urban Institute and Moody's indicated that a full recovery in the housing market "will only happen if there is stronger demand from first-time homebuyers ... we will not see the demand needed among this group if access to mortgage credit remains as tight as it is today."

▶MAKING UP WITH THE AGENCIES

For Wells Fargo, a critical factor in its new strategy is clearing up disputes with Fannie Mae and Freddie Mac. The 2013 settlements for $1.3 billion resolved differences in a 5-year battle between banks and government mortgage agencies over who was responsible for losses from the mortgage crisis. The bank still has mortgage problems to clear up with the agencies, including a lawsuit linked to the Federal Housing Administration (FHA), but the bank officials believe the worst is over.

Wells Fargo avoided many of the worst loans of the subprime era. For example, It did not offer option adjustable-rate mortgages. However, when it acquired Wachovia in 2008, the bank inherited a $120 billion portfolio of "Pick-A-Pay" mortgages where borrowers could defer payments on their loans. Those loans resulted in big losses.

Banks are currently cautious because Freddie Mac and Fannie Mae have been pressing lenders to purchase back home loans that went bad after the crisis. The agencies guaranteed the loans and believe that the banks overstated the mortgages' quality, or made mistakes in documentation.

Banks believe the agencies used minor mistakes as a means to pressure banks to purchase back loans. Following the settlements, Wells Fargo is more confident about the underwriting errors the agencies consider material, and the quality of the documentation needed to avoid such costly differences in the future.

Wells Fargo is not just opening up the lending faucets. The bank is looking to lend to borrowers with weaker credit, but only if those mortgages can be guaranteed by the FHA. Because the loans are backed by the government, Wells Fargo can package them into bonds and sell them to investors.

The funding of the loans is a key difference between Wells Fargo and other lenders. The smaller, nonbank lenders, are making mortgages known as "nonqualified loans" and are often holding them on their books, but the big banks are packaging the mortgages into bonds and selling them to investors.

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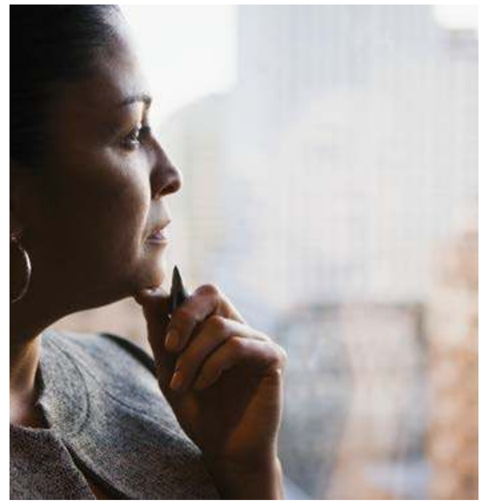
BUYERS DILEMMA – A LACK OF QUALITY ASSETS

By Stuart Eisenberg, Assurance Partner



As noted in the first quarter 2014 PricewaterhouseCoopers Real Estate Survey, investors in the commercial real estate (CRE) industry are optimistic, eager and well- capitalized, but the missing piece of most acquisition strategies is quality offerings. Exacerbating this situation is that access to both debt and equity capital continues to improve with very attractive interest rates and loan terms for top-notch deals.

The report indicated that in the office sector, top-performing office markets continue to be where many investors prefer to invest, which is resulting in too much capital chasing ad too few deals. This has created situations where the desire to maintain underwriting discipline and the need to address investor demands to deploy or return capital may be in conflict. The search for "value-added" opportunities that provide greater returns is challenging in an environment where buyers are using aggressive lease-up and rent growth assumptions to support pricing.

For the apartment sector, there appears to be more of a focus on development opportunities and watching this sector's expanding supply pipeline. Avoiding oversupply in the long-term is a challenge. There are many new apartment developments underway or in the

CONTINUED FROM PAGE 2

BUYERS DILEMMA

planning stages and combining this with an expected slowdown in rental demand could signal a surge in offerings, as the number of apartment markets in the contraction phase of the real estate cycle grows.

In particular, as investors look to capitalize on the ongoing recovery in the U.S. warehouse sector, an imbalance is developing as the number of eager buyers, which now includes family offices, sovereign wealth funds and other international investors, are competing for a limited amount of quality offerings. Still sales of significant industrial properties totaled $4.2 billion in January 2014, up 47.0 percent on a year-over-year basis, but down from the prior month, according to Real Capital Analytics (RCA).

The conundrum for buyers is that although some investors expect the number of quality assets to grow throughout 2014, due to upcoming debt maturities and stronger CRE fundamentals that prompt owners to sell, there is speculation in the market that owners will opt to hold stabilized assets, especially in the office sector, in order to capitalize on the expectation of growing rents and to avoid the task of determining where to redeploy capital.

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PErspective in Real Estate

As dry powder continues to accumulate, private equity is eager to identify opportunities to deploy capital. According to ***Prequin***, at the end of 2013, the private equity industry held a record $1.074 trillion in dry powder that was yet to be invested. However, as indicated by findings from BDO's ***Fifth Annual PErspective Private Equity Study***, despite significant cash holdings, fund managers continue to face challenges, as they look for opportunities to invest in 2014, in particular in terms of pricing and the ability to identify quality targets.

For the real estate industry, these challenges are driving an increasing number of private equity investors to look outside of the U.S. real estate market, specifically in regions that are in the midst of economic recovery, for example Southern Europe and emerging markets, for investment opportunities.

Southern Europe, a region many private equity investors avoided for years, due to political and economic instability, is becoming an increasingly popular area for real estate investment. As the economy stabilizes, banks in Italy and Spain are offloading assets, including significant real estate portfolios, and private equity funds are taking advantage of the opportunity. In Italy, ***Reuters*** recently reported that five U.S. private equity funds have expressed interest in Banco Popolare (BAPO.MI) and its significant real estate assets.

Emerging markets present another opportunity to invest in real estate at low cost with high potential returns. While emerging markets generally experience volatility and short-term risk, private equity is willing to take a chance in favor of better pricing opportunities and long-term growth potential. In fact, according to data from ***Palico***, more than $6.5 billion has been raised for emerging market private equity funds in 2014. And, many of these funds are looking to the real estate sector as an opportunity for private equity investment to replace dwindling bank credit in these markets.

That's not to say there is no private equity interest in U.S. real estate. According to findings from the recent ***Akerman Real Estate Industry Outlook Survey***, 70 percent of real estate industry respondents report that they are increasingly optimistic about the commercial real estate market in the U.S., compared to last year, as the U.S. economy improves. Further, respondents identified private equity as the leading source of funding for real estate debt and/or equity funding, followed by REITs and banks. But, as the U.S. economy and the real estate sector continue to improve, private equity funds will be on the lookout for the next big investment opportunity – and right now that's emerging and recovering markets.

PErspective in Real Estate is a feature examining the role of private equity in the Real Estate Industry.

A LOW-RISK REAL ESTATE PORTFOLIO

By John Tax, Assurance Director

To an investor, “shelter” instantly brings to mind tax-free income. But there is another kind of shelter that becomes increasingly important if the threat of economic weakness in the U.S. continues. This is the shelter that comes from an investment position that will not bear the entire brunt of negative economic and financial developments. The best example of such an investment is a first mortgage loan at a reasonable ratio of the market value of prime real estate. The problem with this type of investment is that the return is normally not attractive in today's market. What are the choices open to an investor who wishes to participate in future economic growth but, at the same time, is anxious to avoid the fully exposed operating position?

A good example of such an investment is the commingled real estate fund that was developed by banks, life insurance companies and other institutions in past recessions.

▶SIX CATEGORIES OF REAL ESTATE EQUITIES

The basic philosophy of the fund described above is to avoid the ownership of “naked” property; in other words, to avoid the pure operating position. For this purpose, real estate equity investments can be divided into six categories:

Raw Land

Such a fund avoids investments of this type because of the risk involved and the absence of current cash flow. The risk in raw land speculation lies not only in the difficulty of forecasting the future but also in determining a current value for the land. Land is very hard to value and price declines often are not reflected in appraisals, which generally look backward to past transactions that may have occurred during more buoyant periods.

The fund might invest in raw land, however, only when its position is protected. For example, if the fund has financed a large, established agribusiness company via subordinated debt that carries an option to buy prime farmland in a fixed period of time at a fixed price below today's appraised value. In this way, the fund obtains expert management, a current cash flow and a call on desirable land in the future.

New Construction

The fund also avoids equity investment in new development where the other partners to the venture put up only a token hard dollar amount. In today's economy and tight money market, new construction often involves unjustified risk.

Here again, however, investments will be made by the fund under the right circumstances. The fund might finance a Florida retirement community with a deferred interest loan, with interest payable only in the last years of the development program when cash flow will be available. In exchange, the fund obtains a partnership equity position and a large bonus interest return at the loan's maturity. More important, the developer has a large hard dollar equity investment in the project.

Unsubordinated Sale and Leasebacks

This type of investment is at the other end of the scale, being too close to a mortgage for an equity fund. In this type of transaction, the fund buys the land for a term of up to 40 years (including renewal terms). The land is not subordinated to the tenant's mortgage and, thus, is not subject to foreclosure if the tenant fails. As a result, the lender in effect holds a mortgage, with a kicker represented by the residual value of the land. In today's market, this residual does not add more significantly to the straight rental return. These investments are more appropriate for a mortgage fund.

Subordinated Sale and Leasebacks with High Credit Corporations

In this case, the institution owning the land agrees to subordinate to the tenant's mortgage. In consideration for the easier financing thus made available to the tenant, the institution obtains an extra yield via a participation in income or similar kicker arrangement. These investments, although difficult to find, are probably the best long-term investments in real estate. The fund should seek them out (although to preserve the fund's tax-exempt status, it participates through a private, institutionally owned real estate investment trust).

▶CONTINUED FROM PAGE 4

LOW-RISK REAL ESTATE PORTFOLIO

Investment in Real Estate Companies

In order to take an indirect position in income properties, the fund could also invest in equity-type real estate investment trusts and in real estate companies that construct and own properties for their own portfolios. In the latter case, the real estate company may form a subsidiary, with the fund investing via the purchase of senior fixed income securities carrying an equity participation.

In one example a well-known realty company formed a new entity to buy substantially completed income properties. The entity was capitalized at $6 million; the fund put up $4 million in exchange for 8.75 percent notes secured by second mortgages on the properties; the realty company put in $2 million in return for preferred stock. The common stock, with a token capitalization, was split one-third to the fund, two-thirds to the realty company. Since the capital will support triple its amount in mortgages, the total program amounted to $24 million. The new entity would only purchase properties recently completed or nearing completion; in that way, development risks are avoided and the economic cost per square foot can be established with some clarity.

Direct Investment in Income Producing Properties

In certain cases, direct property investment can be regarded as “protected.” These are existing properties with a well-established cash flow and a low vacancy ratio. The difficulty here is that prices are likely to be very high in today’s market. Assuming a management fee of 1 percent or more for adequate supervision, cash yields might amount to about 7 percent. If the fund's goal is a 10 percent return, it would need to count on a substantial growth of rental income in excess of operating expense. On the whole, this cannot be anticipated.

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GREEN LEASE LEADERS PROGRAM: RECOGNITION

By Alvin Arnold

Builders and developers have earned recognition in the past 10 years for elevating the U.S. Green Building Council’s Leadership in Energy & Environmental Design (LEED) program into an industry standard, but the commercial real estate experts in charge of the next step – how the sustainability plans get carried out – have been ignored until now.

The Green Lease Leaders Recognition Program began in mid-January 2014. The program, sponsored by the Department of Energy’s (DOE) Better Building Alliance, will provide brokers, landlords and tenants who participate in the program the chance to add a marketable “Green Lease Leader” seal after the name. To apply, brokers must provide examples of their green leases to the Washington, D.C.-based Institute for Market Transformation, which will manage the recognition program for the DOE.

Green leases are contracts that align the financial and energy incentives of building owners and tenants working together to save money, conserve resources and ensure the efficient operation of buildings. Some common components of a green lease that go beyond standard cost-recovery clauses include provisions that require energy- and water-usage data. An agreement on operating schedules to maximize energy savings during off-hours (nights and weekends) and clauses encouraging energy-efficient tenant fit-outs should also be agreed to.

▶GREEN LANGUAGE IN LEASES

Other industry programs recognize green-minded building professionals, but these programs, such as the LEED AP program for brokers, require much more green engineering knowledge than how a lease is structured. Green language in leasing, in practice, is still relatively young, and it is a part of a lease that is generally not shared publicly. It is hoped this recognition program will elevate knowledge and awareness, and encourage conversations with clients about why adding the green requirements to the lease, rather than just having a recognized building label, will keep the sustainability programs from falling short.

▶GROUND LEASE/NET LEASE: SPLIT INCENTIVE

In 2013, the Alliance released two case studies featuring tenants who incorporated green lease standards. One company was in the retail space and the other was in the office

CONTINUED FROM PAGE 5

GREEN LEASE LEADERS PROGRAM

space. Both companies had to battle what has held green leasing back: the problem of "split incentive." Gross leases do little to encourage the tenants to save energy because the costs are paid by the landlord. Net leases, on the other hand, give tenants more incentive to save money, but landlords then have the added burden and expense of gaining access to tenants' energy-use data to make informed sustainable spending decisions.

The case study included a 1.3 million square foot retail complex. The property has sustainable features such as a green power purchase agreement, a rainwater harvest system and energy-efficient lighting systems. However, the standard leases do not reflect the needs of the sustainable features, so the company implemented green language in the leases to achieve the LEED Interiors certification.

The other firm included a clause to get past the net lease split incentive problem, requiring tenants to either submit monthly utility data or allow the landlord to install submeters to track energy usage. The company was able to incorporate the clause into all new leases in 2012, covering roughly 1.8 million square feet. It has experienced very little resistance to the new contract requirement.

Some examples of green lease language, provided by the DOE, include:

> "Landlord is hereby authorized to request and obtain, on behalf of Tenant, Tenant's electric consumption data from applicable utility provider."

> "Notwithstanding anything herein to the contrary, if Landlord reasonably determines that Tenant's use of electricity is excessive, Tenant agrees to pay for the installation of a separate electric meter to measure electrical usage in excess of normal office use and to pay Landlord for all such excess electricity registered in such submeter."

The Green Leaders program is working closely with the largest landlords and brokerage firms as well as all industry associations to be sure there is a comprehensive awareness that will help achieve their long-term goals of sustainability and conservation.

Reference: NREionline

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