

THE NEWSLETTER OF THE BDO REAL ESTATE AND CONSTRUCTION PRACTICE

REAL ESTATE & CONSTRUCTION **MONITOR**



PROPTech – IS 2017 THE YEAR THINGS CHANGE FOR THE PROPERTY INDUSTRY?

By Ian Shapiro

Technology has been a disruptive force in most industries and sectors over recent years. But in the real estate and construction (REC) sector, widespread adoption of new technologies has lagged somewhat.

Indeed, the adoption of technology in property – or 'PropTech' – has fallen a little short of its anticipated take-up. For example, in the U.S., the construction industry is several years behind many other industries with regards to technology with many companies still using manual systems for project planning and management. That's why construction

remains far behind in reaping the benefits of advanced data and analytics, drones, automation and robotics.

However, 2017 is set to be the year the floodgates open for PropTech in the global REC sector, and we've looked at some key technologies you should be keeping an eye on in the industry this year.

THE WIDESPREAD USE OF DRONES

Drones have been in the news for various reasons recently – both good and bad. Thankfully, they are being put to good use in the construction industry and we're seeing things get far more efficient on

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BDO's Real Estate and Construction practice consists of multi-disciplined professionals who are well-versed in compliance and consulting matters. Our professionals have many years of experience in financial reporting and accounting, tax and auditing issues and are continually updating their knowledge and, therefore, are dedicated to giving timely and accurate advice.

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projects because of them. They can be used during surveys to check the condition of hard to reach places and can be equipped with lenses that are able to read serial or model numbers, meaning that surveys can be performed in detail.

Drones not only save time (and therefore money!) but also improve safety for construction workers. For example, a roof survey would normally involve human workers climbing onto the roof, which naturally involves considerable risk. By using drones, construction companies are able to bypass this risk, without losing much, if anything, in the way of accuracy.

For this reason, we are now seeing a wider adoption of drones by construction companies. However, the popularity of this technology has had the knock-on effect of bringing in increased regulation: aviation authorities around the world have introduced regulations for drones because of perceived privacy and security concerns, with many countries now demanding licenses or permits to use drones for certain activities or around important landmarks.

VIRTUAL REALITY – FROM GIMMICK TO LEGITIMATE TOOL

The use of virtual reality (VR) in property is already a \$1 billion global industry and Goldman Sachs estimates that it is set to treble by 2020. VR has its obvious uses in the real estate sector: for example, VR is used for sales and marketing in the prime residential market, where investors often live miles away from the properties they want to view.

VR is also viewed as the next phase of Building Information Modeling (BIM), and as an enhancement to computer-aided design (CAD): developers can use VR to create more realistic and detailed renderings, which are now transitioning into virtual reality walkthroughs.

Certainly, 2017 will see virtual reality transition from gimmick to a legitimate tool across the REC sector as the

emergence of VR headsets, interactive hand controllers and movement sensors revolutionize how designers and contractors experience the construction process.

THE CLOUD AND REAL-TIME DATA

Increasingly, supervisors are turning to the cloud and real-time data to stay abreast of construction jobs. With the help of smart devices, such as an iPad or an iPhone, foremen and supervisors can follow a project in real time and identify specific "milestones" that can be checked off as a job progresses, causing invoices and payments to vendors or subcontractors to automatically generate accordingly.

SMART TECH FOR SMART BUILDINGS

The term "smart building" has been in use for some time but smart technology is now making a real impact on the real estate sector. Buildings are now designed to be "smart," which is making tenants' and property managers' lives easier.

By using smart devices to control things like heating and lighting, residents can decrease their bills and energy waste. Similarly, elevators can be programmed to reduce usage and automatically tell building managers when they need to be serviced. Here, PropTech is not only improving efficiency but also safety.

ROBOTS IN REAL ESTATE

The construction industry has yet to really adopt robotics although human-controlled machine equipment is widely used. The use of robots for high-precision activities is not new (consider welding or vehicle painting) but advances that allow robots to "see" via sensors mean that robots can now be used to perform previously human-only tasks, such as "couriering," cleaning or gardening in hotels, warehouses or office buildings. I was recently given a coffee by a robot at a PropTech conference!

CYBER ATTACKS DRIVE INTEREST IN SECURITY

In construction, cybersecurity issues are only now making an impression but in real estate, it is a real issue, especially as buildings become increasingly "smart" and therefore vulnerable. Thanks to the Internet of Things, everything down to your Christmas tree lights can now be controlled electronically; thus, buildings are becoming the new target of cyber attacks.

The use of ransomware is increasing and becoming more targeted to property. In recent years, it was claimed hackers stole the blueprints to Australia's secret service agency HQ, presenting obvious terrorist threat concerns. It is therefore understandable that landlords and building owners would be concerned for the security of their assets, and must work with cybersecurity experts to protect their business.

Given the REC industry's poor track record on innovation and the adoption of new technologies, tools and approaches, governments, developers and deliverers need to invest collectively to achieve these shared goals and future-proof the industry. In order to achieve this, firms need to develop digital road maps, appoint dedicated staff to think boldly about the digital agenda and partner with technology firms. BDO recently took a huge step toward this by partnering with Microsoft (read press release [here](#)).

This is the digital age of collaboration, and the industry will soon come to realize that digital tools can be more powerful than the ones in a rusty toolbox. We all need to embrace this catalyst for change to attract a new generation of talent.

This article originally appeared on the BDO Global Real Estate & Construction blog. View the original post [here](#).



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MAKING REAL ESTATE INVESTMENTS ATTRACTIVE TO TAX-EXEMPT INVESTORS

By David Patch

Organizations described in sections 401(a) and 501 are generally exempt from federal income tax, except with respect to income from businesses that are unrelated to their tax-exempt purpose, known as unrelated business taxable income (UBTI).¹

Rents from real property are specifically excluded from UBTI, making rental real estate partnerships a potentially attractive investment for many exempt entities. Otherwise excluded rental income, however, becomes taxable UBTI to the extent the property is funded with debt.² Given that leverage is ubiquitous in real estate investments, this presents a problem for exempt entities except in those rare situations where the real estate is entirely funded with equity.

Some types of exempt entities can avoid UBTI on debt-financed real estate investments if certain requirements are met. In order to attract such investors, many real estate funds carefully structure

the terms of their operating agreements to meet these requirements and advertise their compliance in offering documents. This opens up a new source of funding for syndicated real estate investment partnerships that might otherwise have appealed mainly to taxable investors.

The types of tax-exempt entities to which these rules apply include educational organizations and their affiliated support organizations, qualified trusts under section 401 (pension, profit sharing and stock bonus plans), certain title holding companies,³ and retirement income accounts of churches (collectively, Qualified Organizations or QOs).

In order for a QO's investment in a real estate rental partnership to qualify for the exclusion, the partnership must meet one of the following requirements:

1. All the partners of the partnership must be QOs;
2. Each QO's distributive share of each item of income, gain, loss, deduction, credit and basis of the partnership must

be the same and must remain constant during the entire period the entity is a partner in the partnership; or

3. Each partnership allocation must have substantial economic effect and satisfy the "fractions rule."⁴

Partnerships in which all the partners are QOs are rare, so the first requirement would not generally be met by a syndicated real estate fund. The second requirement is extremely restrictive and could limit the ability to structure deals in a way that will be of broad appeal. Therefore, real estate funds hoping to attract QOs as investors will generally want to meet the third test.

One requirement of this test is that the allocations provided for by the partnership agreement have substantial economic effect.⁵ Among other things, partnership agreements must generally provide for liquidating distributions in accordance with positive capital accounts in order to meet this requirement. Partnership agreements frequently define liquidating distribution rights in other ways, and such

¹ Section 501(a), section 512.

² Unrelated debt-financed income, Section 514.

³ As described in section 501(c)(25).

⁴ Section 514(c)(9)(B)(vi).

⁵ Section 514(c)(9)(E)(i).

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an agreement would generally fail this requirement.⁶ A real estate partnership hoping to attract QOs would need to ensure that its partnership agreement is drafted in a way that causes its allocations to have substantial economic effect. Virtually any partnership's economic arrangement can be defined in this manner so meeting this requirement should not be a particular hardship, but the desire to do so must be communicated to the drafting attorney.

The more difficult requirement is that the partnership's allocations satisfy the fractions rule. The fractions rule is met only if "the allocation of items to any partner that is a qualified organization cannot result in such partner having a share of the overall partnership income for any taxable year greater than such partner's share of the overall partnership loss for the taxable year for which such partner's loss share will be the smallest."⁷ Thus, for example, a QO could not generally be allocated 10 percent of the partnership's loss in one year and 11 percent of the partnership's income in another. This seemingly simple requirement may prove difficult to achieve in practice because most real estate funds have allocations that vary or have different classes of interests that cause allocations to change from year to year. The promoter's interest will generally also vary depending on whether and when investment return hurdles are reached. In recognition of these common issues, the regulations provide a number of exceptions under which certain variances are ignored, including:

1. Allocations reflecting a preferred return or guaranteed payments for capital computed at a commercially reasonable rate.
2. Guaranteed payments to the tax-exempt member for services if reasonable in amount.

3. Allocations of income made to reverse prior disproportionately large allocations of overall partnership loss or disproportionately small allocations of partnership income to a QO.
4. Special allocations required by the Internal Revenue Code or regulations such as minimum gain chargebacks and qualified income offsets, as well as provisions that prevent allocations of loss to a QO if it would create a deficit capital account.
5. Special allocations of certain partner-specific expenditures such as the costs of additional record-keeping and accounting incurred in connection with the transfer of a partnership interest, additional administrative costs that result from having a foreign partner or state and local taxes.
6. Special allocations of certain unlikely losses, such as litigation costs or casualty losses.⁸

In addition, the regulations make the fractions rule inapplicable if (1) QOs do not collectively hold interests of greater than five percent in the capital or profits of the partnership; and (2) taxable partners own substantial interests in the partnership through which they participate in the partnership on substantially the same terms as the qualified organization partners.⁹

In 2016, regulations were proposed that would modify several of these exceptions in ways that should generally make them easier to satisfy and add additional exceptions. For example, the proposed regulations would:

1. Remove a requirement in the existing regulations that preferred returns be distributed currently in favor of a requirement that unpaid amounts compound and be distributed first.
2. Allow special allocations of management (and similar) fees to

account for separately negotiated economic arrangements.

3. Allow for special allocations intended to reverse prior special allocations of unlikely losses.
4. Allow certain allocations to account for changes in ownership due to staged closings.
5. Allow for changes in allocations due to unanticipated defaults on or reductions in capital contribution commitments.
6. Clarify how allocations from lower-tier partnerships are taken into account.
7. Add a de minimis exception for partnerships in which non-QO partners do not own in the aggregate interests of greater than five percent in capital or profits.

The proposed regulations will be effective when finalized, but partnerships may apply the rules for taxable years ending on or after November 23, 2016.

CONCLUSION

Syndicated real estate partnerships that fail to satisfy the fractions rule may be missing out on a valuable source of investment capital. By working closely with partnership specialists, syndicators can ensure that their funds meet the requirements for the exclusion of debt-financed income and present an attractive investment opportunity for QOs. Proposed regulations issued in 2016 will make it easier for real estate partnerships to satisfy the fractions rule, making this a great time to consider (or reconsider) taking the steps necessary to comply with the requirements.



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⁶ Allocations provided by partnership agreements that do not call for liquidating distributions in accordance with positive capital accounts may meet this requirement only if they have substantial economic effect "equivalence." To qualify, the allocations must result in ending capital accounts that reflect liquidating distribution priorities at the end of the current and all future years.

⁷ Section 514(c)(9)(E)(i)(I).

⁸ See generally Treas. Reg. sections 1.514(c)-2(d) through (j).

⁹ Treas. Reg. section 1.514(c)-2(k)(2).



ANOTHER YEAR WISER: TAKEAWAYS FROM REITWISE 2017

By Brandon Landas and Jan Herringer

In mid-March, leaders throughout the industry gathered in sunny California for NAREIT's annual Law, Accounting & Finance Conference.

Presentations spanned financial, accounting, tax, legal and political issues for REITs and real estate companies. Here are some of the event's top takeaways from REITWise 2017.

Accounting for New Standards: Lease Accounting & Revenue Recognition

Throughout the conference, the Financial Accounting Standards Board's (FASB) new Lease Accounting Standard, ASC 842, was a key topic of discussion. While the lease accounting guidance will have a more direct impact on REITs' tenants, the industry is closely monitoring how their tenants are adjusting to the new standard. That said, REITs with ground and equipment leases will be directly impacted by the new standard. The changing guidance around revenue recognition under ASC Topic 606: Revenue from Contracts with Customers was also discussed at length. The new revenue recognition accounting standard takes effect in 2018, and the new lease accounting standard will become effective for public companies in 2019. That means now is the time for REITs to adopt an implementation plan and assess each standard's impact to their operations and bottom line.

Dusting up Disclosure Requirements:

As part of the SEC's Disclosure Effectiveness initiative, designed to improve the disclosure regime for both companies and investors, the SEC issued a Disclosure Update and Simplification Release (DUSTER) proposed rule in July 2016. While the SEC is deliberating how to move forward with the disclosure requirements, there are voluntary steps companies can and should take. Proactive measures REITs can adopt now include eliminating some archaic information in filings and streamlining repetitive and complex document language. REITs would also be wise to closely review existing disclosures and take proactive measures to improve their effectiveness—with an eye toward making them easier for shareholders to read.

Going Concern Update – Implications for Management and Auditors:

Accounting Standards Update 2014-15, *Presentation of Financial Statements – Going Concern (Subtopic 205-40) Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern*, became effective at the end of 2016, specifically, for annual periods ending after December 15, 2016, and for annual and interim periods thereafter. This update, among other matters, includes a new requirement for management to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt

about the entity's ability to continue as a going concern within one year after the date the financial statements are issued (or within one year after the date that the financial statements are available to be issued, when applicable) and to provide certain related disclosures. Previously, there was no guidance in generally accepted accounting standards (GAAS) about management's responsibility with respect to going concern.

In September 2014, the PCAOB issued Staff Audit Practice Alert (Staff Alert) No. 13, *Matters Related to the Auditor's Consideration of a Company's Ability to Continue as a Going Concern*. This Staff Alert reminded auditors of public entities to continue to look to the existing requirements of PCAOB AS 2415, *Consideration of an Entity's Ability to Continue as a Going Concern*, when separately evaluating whether substantial doubt regarding the company's ability to continue as a going concern exists for purposes of determining whether the auditor's report should be modified.

More recently, in February 2017, the Auditing Standards Board of the AICPA issued Statement on Auditing Standards (SAS) No. 132, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern (SAS 132)*. This SAS will be effective for audits of statements of nonissuers for periods ending on or after December 15, 2017, and reviews of

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interim financial information for interim periods beginning after fiscal years ending on or after December 15, 2017. SAS 132 clarifies that the auditor's objectives with respect to going concern matters include separate determinations and conclusions from management regarding (1) the appropriateness of management's use of the going concern basis of accounting, when relevant, in the preparation of the financial statements, and (2) whether substantial doubt about an entity's ability to continue as a going concern exists, based on the evidence obtained, for a reasonable period of time as defined in the applicable financial reporting framework.

Don't Bet All Your Marbles on Infrastructure Investment:

A big topic of discussion throughout the conference was the much-lauded trillion-dollar investment in infrastructure candidate Donald Trump discussed last year on the campaign trail. Enthusiasm has waned, however, since the White House published its preliminary budget blueprint. The proposal includes a \$2.4 billion, or 13 percent, cut to the Department of Transportation's budget, raising alarm bells for the sector. Earlier this year, REITs and real estate companies were bullish on infrastructure development and public-private partnerships (P3s). In light of the recent developments, though, infrastructure investment is less of a surefire win, leading many REITs to reevaluate their next moves.

For a look at tax reform and other issues discussed at REITwise, watch a [NAREIT video interview](#) with BDO's Scott Smith, national practice leader for state and local tax, filmed during the conference.



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PErerspective in REAL ESTATE

A FEATURE EXAMINING THE ROLE OF PRIVATE EQUITY IN THE REAL ESTATE SECTOR.

Brick & Mortar Retailer Woes Raise Concerns Despite Spiking M&A Activity

The retail model is undergoing a transformation that presents opportunities and risks for the real estate industry. Driven by changing consumer expectations about brand experience and convenience, traditional retailers are scrambling to expand their online and omnichannel offerings, while online retailers are laying down their first bricks and mortar. And despite recent headlines touting retail's demise off the back of Q1 earnings, there's been a sustained spike in e-commerce deal activity among strategic and financial buyers that suggest interest in transforming the current retail model is rapidly growing.

REITs operating in the retail industry are keeping a close eye on the sector's fiscal health—which has a direct impact on their bottom line. While the retail industry is sending investors somewhat mixed signals, the future of retail will likely be less dependent on growing brick-and-mortar footprints and more focused on developing the right balance of consumer channels. Embracing e-commerce is not synonymous with shuttering physical locations, as storefronts remain an integral element of the retail mix. Retailers that take active steps to grow their multichannel offering while right-sizing their in-store footprint look to be better positioned than competitors who have yet to take steps to address the rise of e-commerce.

The Good

General retail e-commerce M&A activity topped out at \$17 billion in 2016, representing about an eightfold increase from 2014's \$2.36 billion in M&A activity, according to [BDO & Pitchbook's Current State of E-Commerce](#), which was published in May and outlines strategic and financial deal activity across the sector. Furthermore, retailers expect deal activity to continue to rise in 2017. Nearly half (46 percent) of retail

CFOs surveyed in BDO's [2017 BDO Retail Compass Survey of CFOs](#) forecast an uptick in retail M&A activity this year. More than two-thirds (38 percent) of these CFOs cite competition and consolidation as the driving factors for deals.

Strategic buyers account for the bulk of the increased deal activity in recent years. In fact, more than half of retail CFOs (56 percent) anticipate M&A activity will continue to be driven by strategic buyers in 2017, with an estimated average EBITDA multiple of 7.0, the highest in the Compass Survey's history.

That means the retail industry is likely to see more deals: first, Walmart's acquisition of Jet.com last year, then Amazon's announcement in June of a \$13.1 billion bid to acquire Whole Foods. Grocery has been a retail sector arguably more insulated from e-commerce disruption than others, as customers largely still prefer grocery shopping in stores. Bloomberg reported that Amazon focused heavily on Whole Foods' distribution technology in negotiations, and experts say immediate cost reduction opportunities could be seen in warehouses. Walmart's acquisition was made to immediately bolster its e-commerce presence and to compete with Amazon. Walmart paid a premium (\$3.3 billion) compared to Jet.com's valuation (\$1.35 billion), but it appears to have paid off: The company's global e-commerce sales for 2016 increased 15 percent from the previous year, and its U.S. e-commerce sales gained 36 percent.

The Not So Good

At the same time, there have been recent strategic acquisitions that have delivered less clear results. Look to examples like the 2015 flash-sale startup Gilt Groupe's sale to Hudson's Bay Co. for \$250 million or Bed Bath & Beyond's \$100 million acquisition of One Kings Lane. Both deals enabled the buyers to enter the flash-sale space at a discounted rate, but the market ultimately slowed. Gilt Groupe's sale now seems like a win; however, the brand was previously valued at \$1 billion before losing steam as

the flash-sale trend has slowed. A similar story was told for One Kings Lane. The total acquisition amount was never released, but estimates put the deal around \$150 million, a far cry from the company's previous valuation of \$900 million.

The Ugly

The first quarter of 2017 saw the highest number of bankruptcy declarations by retailers since 2009, during the height of the Great Recession. The number of retailers that have filed for Chapter 11 bankruptcy protection so far this year has already surpassed the total 2016 number, according to reports by *CNBC* and *USA Today*. Financial challenges seem to be hitting mall clothing chains especially hard as consumers shift their spending to more agile online sellers. Of note, roughly half of retailers that have filed for Chapter 11 protection year-to-date were previously purchased by private equity firms, according to *CNBC*. And the number of retailers on Moody's distressed list is also

surpassing Great Recession levels. If this trend accelerates, REITs operating in the retail sector could be impacted by tenant loss or defaults and falling or flat lease values.

Still, surging M&A appetite and a determination by the majority of retailers to transform their business model to meet new customer preferences should provide an opportunity for evolution—for the better, ultimately—for REITs operating in the sector. Retail as we know it is rapidly changing. Just as the industry is different today from what it was 50 years ago, it will be totally transformed by 2067. And our bet is that transformation will come relatively quickly, so there is a good opportunity for disruptors and innovators in the sector to shape what the future model of retail will look like. Identifying, courting and partnering with those disruptors would be a solid strategy for REIT executives.

A version of this article first appeared in Commercial Property Executive. View it [here](#).

DID YOU KNOW...

Foreign investment in the U.S. commercial real estate market totaled \$66.7 billion in the fiscal year ending March 31, a 33 percent decrease from 2015 levels, according to [Real Capital Analytics](#).

Construction spending in March 2017 totaled \$259.5 billion, representing a 4.9 percent increase from the prior year the [U.S. Commerce Department](#) reported.

According to the Bureau of Labor Statistics' [May 2017 Job Report](#), employment in the leisure and hospitality industry increased during the month, with the addition of 31,000 jobs.

Chinese investment in Manhattan commercial property totaled \$2.3 billion in the first four months of 2017, up slightly from \$2.1 billion from 2016. Despite the slight uptick in deal value, the volume of deals fell from eight last year to just two in 2017, [The Real Deal](#) reported.

Blackstone Real Estate Income Trust Inc. raised \$755.4 million by April, accounting for about 41 percent of all fundraising activity in the industry, the [Wall Street Journal](#) reported.

Home values saw a nearly 7 percent year-over-year uptick this March, while median rental prices increased by an estimated 0.7 percent, according to [Zillow](#).

FUTURE PERSPECTIVES: WHAT'S NEXT FOR REAL ESTATE INVESTORS?



The real estate industry, and particularly retail U.S. REITs are bracing for a bumpy road ahead. In fact, REITs' concerns over foreclosure and bankruptcy have jumped in the last year, according to the [2017 BDO RiskFactor Report for REITs](#), which examines the risk factors in the most recent 10-K filings of the largest 100 publicly traded U.S. REITs. This year's report reveals that 86 percent of REITs are concerned about the risk of foreclosure and bankruptcy, up from 80 percent in 2016. Roughly the same amount (84 percent) said falling or flat real estate values are a risk in the year ahead, up from 79 percent in 2016. Meanwhile, three out of four (76 percent) retail REITs point to the growth of e-commerce, specifically as a threat.

To reposition their model in light of the rise of retail e-commerce, some REITs have already begun to take active steps to redefine the consumer in-store experience across their properties. High-end mall REITs have found some success in moving up-market to fill vacancies created when struggling retail chains have moved out, as well as by cultivating a differentiated shopper experience by incorporating more entertainment, activity and dining venues.

The implication is that, while consumers are increasingly seeking to purchase a larger share of their goods online, they remain drawn to brands that deliver a consumer experience before, during and after the transaction. While there may be some right-sizing of retail brick-and-mortar footprints still left to be done, REITs should take comfort in the fact that a new retail model—one that focuses more on brand experience—has started to take shape across the sector. That model will be dependent on a well-defined and prominent in-store component.

MARK YOUR CALENDARS

The following is a list of upcoming conferences and seminars of interest for real estate and construction executives:

JULY

July 16-18

RealWorld 2017

Wynn Las Vegas
Las Vegas

July 18-21

**National Council of Real Estate
Investment Fiduciaries (NCREIF)
Summer 2017**

The Mayflower Hotel
Washington, D.C.

July 20

**Bisnow's Big West Coast Multifamily
Event**

Millennium Biltmore Hotel
Los Angeles

AUGUST

Aug. 23

Bisnow's National Industrial Event

TBD
Chicago

Aug 24

ALM RealShare Orange County 2017

Westin South Coast Plaza
Costa Mesa, Calif.

Aug 27-29

**International Council of Shopping
Centers Florida Conference & Deal
Making 2017**

Orange County Convention Center
Orlando, Fla.

SEPTEMBER

Sept 18-19

NAREIT 2017 SFO Workshop

Fairmont Copley Plaza
Boston

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