# COMMERCIAL REAL ESTATE INSIGHTS AND UPDATES

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CohnReznick

ADVISORY • ASSURANCE • TAX

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# PREFACE

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As the commercial real estate market heads into the second quarter of 2019, valuations and competition for deals continue to test the discipline and strategies of market participants, while economic indicators remain strong and interest rate uncertainty has dissipated. This combination of forces means that the market is less frenetic but no less intense. Indeed, some of that energy is being directed internally, as firms redouble their focus on operations, efficiency and technology, and recalibrate their tax strategy as the dust continues to settle from the Tax Cuts and Jobs Act.

In this edition of CohnReznick's *CRE Insights & Updates*, our experts offer their perspective on these developments, as well as provide overviews of trends in fundraising, foreign investment, and key market sectors. *CRE Insights & Updates*, which will be published throughout the year, replaces our annual *CRE Momentum* report. This allows us to share our industry observations at a frequency that better matches today's dynamic real estate market.

As always, we welcome your comments and feedback.

Best regards,

Ronald A. Kaplan
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# TAX STRATEGIES FOR 2019

## As regulatory dust settles, investors flock to an opportunity

In 2019, tax strategies for commercial real estate are dominated by challenges associated with necessary adjustments due to the Tax Cuts and Jobs Act (TCJA), the most sweeping tax reform legislation in a generation. While there are several notable provisions regarding deductions and taxable income, two stand out as being particularly important from a tax planning perspective.

### Section 163(j)

The first is the proposed limitations on business interest expense deductibility under Section 163(j). Though real estate got a much-needed carve-out from the new 30 percent cap, electing out of the deduction limitation requires using the slower alternative depreciation system. Charting an optimal strategy for this tradeoff requires a detailed analysis for every building in an investment portfolio. Residential rental real estate is proving to be the most affected asset class, given that an election out of the 163(j) business interest limitation requires a change in depreciable life from 27.5 to 40 years. The resulting reduction of depreciation expense could eclipse the benefit of deducting all business interest. Other commercial real estate asset classes are experiencing a much less significant change to depreciable lives, from 39 to 40 years, and often the choice to deduct 100 percent of business interest is made. In addition to the immediate depreciation impacts mentioned above, forward-thinking strategy is required to consider upcoming capital improvement plans, refinancing, and capital structure changes to ensure that the 163(j) analysis is comprehensive. The election out of 163(j) is an irrevocable election once made.

### 20% Pass-Through Deduction

The second particularly noteworthy provision is the new 20 percent exclusion from pass-through income in Section 199A. The provision has the potential to provide real estate owners and investors with a sizable tax deduction, but much depends on the W-2 wages paid by the entity distributing the income, among other factors. The guidance issued in mid-January provided some welcome assistance in interpreting more than 400 pages of regulations, but there are still numerous questions that invite differences of opinion even among experienced tax professionals. This year's tax season will thus be accompanied by an unavoidable level of uncertainty that will likely dissipate only as further guidance is issued and standard practices emerge over the next year or two.

### Opportunity Zones

For many in the commercial real estate industry, however, the TCJA's biggest news was the creation of opportunity zones and the associated tax deferment and basis step-up benefits. While opportunity zones are new, they are the latest in a long line of tax incentives that recognize the power of real estate investment to stimulate economic development (although the opportunity zones program reaches past real estate to cover other business investment).

Of course, policy never unfolds in a vacuum, and it will be interesting to see how two factors in particular affect this program's development. The first is that opportunity zones are being introduced just as socially responsible investing (SRI) is moving from the periphery to the mainstream. Qualified Opportunity Funds – the vehicles that invest in opportunity zones – provide a new channel for the growing numbers of family offices, institutional investors, and others that are embracing SRI strategies.

The second factor lies in the fact that underdeveloped urban areas have been a focus of investment for a full decade before opportunity zones were established. To be sure, the opportunity zone program includes areas that lie outside those that have received attention. But an argument can be made that the program is as much accelerating a process already in place as it is redirecting investment to overlooked areas. This isn't necessarily a bad thing. But it will be worth noting how the opportunity zones program affects an already competitive market – and the extent to which it achieves its policy objectives.

# INVESTORS AND FUNDS ADJUST THEIR FOOTING TO MOVE IN A MORE CAUTIOUS MARKET

Last year's real estate funds and fundraising patterns showed the market move into a more deliberate and cautious phase. Fundraising contracted somewhat due to concerns about lofty market valuations and the potential for a market correction. A total of 298 real estate funds closed with $118 billion globally, according to preliminary Preqin data. That compares to 406 funds raising $132 billion in 2017. While Preqin expects the 2018 numbers to rise as much as 10 percent in its final tally, that would still leave them below 2017 levels. And the U.S. didn't escape the decline. In North America, private equity vehicles raised $44 billion last year, down about 30 percent from 2017, according to Private Equity International (PEI).

For those who did invest, tenuous market sentiment helped push them to bigger funds at bigger firms. A sense of investor deliberation was also apparent in the 18 months it took funds that closed in 2018 to do so – a 10-year high, according to Prequin. At the same time, though, 45 percent of those funds topped their targets, a five-year high, and dry powder reached $295 billion.

But if investors moved more cautiously, they were still ready to take on risk when the moment was right. Value-added funds attracted $36 billion globally and opportunistic funds garnered $43 billion, according to Preqin. More conservative core and core-plus funds, on the other hand, brought in a mere $6 billion, a roughly 60 percent plunge from 2017. But the appetite for risk didn't keep investors away from debt funds, which raised a strong $26 billion. So it appears that investors adopted a barbell strategy, opting for risk at one end of the bar and safety at the other. Tellingly, investors remain committed to the asset class: About 80 percent of institutional investors surveyed by Preqin say they will keep their real estate investments the same or increase them in 2019.

Real estate fund managers seem to hold a similar balance of caution and readiness. While they voice concerns that high valuations and any return of interest rate concerns could make it difficult to produce strong returns, 2019 started with 674 real estate funds seeking $250 billion in funding. That includes the behemoth Blackstone Real Estate Partners IX, with a target of $18 billion, which would make it the largest real estate fund ever assembled by the private equity titan.

As for market sectors, industrial and multifamily have dominated fundraising since 2013, and there are no signs of that trend changing anytime soon. Industrial-oriented funds took in $12 billion last year, and multifamily absorbed $10 billion, according to PEI.

Meanwhile, the trend toward crowdfunding continues apace. Regulation A+ of the 2012 Jumpstart Our Business Startups (JOBS) Act has led family offices and high-net-worth individuals to invest in real estate funds of up to $50 million. Another business model that has proven popular allows accredited investors to invest in specific real estate assets. In December, a major development in New York City's Times Square attracted about $400 million from UBS Group's ultra-high-net-worth and family office clients. The traction achieved by this new fundraising model is a double-edged sword for private equity real estate funds. On the one hand, the money going to these specific projects might otherwise have flowed through funds. On the other, this capital pool provides real estate funds with another source of co-investors. It will be interesting to watch in the year ahead how the market arranges itself to best take advantage of these emerging funding channels.

# HELPING TO UNLOCK REAL VALUE IN REAL ESTATE

## Pushing past technology adoption to embrace a holistic strategy

Commercial real estate firms today face increasing performance pressure from all sides. The emphasis on efficiency is relentless. Investors demand greater transparency. Commercial tenants expect building owners to be true strategic partners, while residential tenants expect the delivery of a complete lifestyle experience.

In today's highly competitive environment, it's no longer effective to have information scattered over hundreds of spreadsheets, or to use manual processes, which provide little transparency, control, or integration. While CFOs rely on new technology to help with back-office systems and upgrades, these technology solutions must be connected across the organization to provide holistic insights into critical business issues and performance gaps.

Identifying where to begin often presents a roadblock, but charting a strategic roadmap is an effective first step. By aligning technology strategy with business goals, an organization can better respond to the demands of today's ever-changing, competitive marketplace.

### Moving past "analysis paralysis"

When it comes to aligning technology with business strategy, the wave of uncertain variables can overwhelm even the most steely eyed CFO – or worse, lead to choosing an expensive piece of technology that doesn't solve core business issues and falls short of expectations. Solving this dilemma begins with stepping back from the technology altogether and addressing the following five points:

1. **Identify stakeholders** – IT strategy is no longer held solely within the IT department. Depending on the size and structure of an organization, key stakeholders most often include members of the C-suite.

2. **Define business goals** – Whether creating more accurate forecasts, improving operational efficiencies, or providing tenants with more responsive buildings, technology management should align with business goals and operations. Reliance on multiple, nonintegrated IT systems can cloud visibility into processes and performance. Similarly, it's important to include measures to eliminate organizational silos to better integrate the processes, data, and goals across lines of business.

3. **Address external market conditions** – To identify current and future opportunities in technology, organizations should preemptively prepare for market disruption and shifting industry realities.

4. **Manage for change** – When technology implementation is perceived as just another initiative with a limited shelf life, the entire endeavor can become a missed opportunity for real change. IT initiatives are only as successful as the change management behind the effort. CFOs and related business leaders should be prepared to continually manage the cultural uncertainties that accompany strategy revisions and recognize that change is a constant.

5. **Educate users** – To optimize the true value of a technology investment, organizations should build in education to ensure that the new technology is well understood and effectively adopted by users.

### Forging ahead

Whether a company needs to transform its entire technology ecosystem or implement a single business solution, companies that can shift from a reactive approach to strategic planning will be better poised for growth. The range of challenges can seem daunting, but a well-planned roadmap based on business objectives and corporate culture can help organizations look at each opportunity as a chance to improve decision-making and drive performance.

By approaching strategy holistically, the work done now can create a scalable and adaptable platform that can grow with the firm. As a data-driven ecosystem emerges, newly connected operations will empower departments to shift value creation from managing square footage to identifying strategic business opportunities and uncovering unchartered competitive advantages.

# FOREIGN INVESTMENT

## In the face of challenges, a new generation steps to the fore

For the past several years, foreign investors – from sovereign wealth funds to syndicates of foreign high-net-worth individuals – have been a reliable component of the U.S. commercial real estate investor base. The trend appears to have continued into 2019, but with some important caveats.

First, there are now various impediments to the inbound flow of foreign capital. The sustained drop in oil prices has slowed investment from the Middle East, and Chinese investors are facing their government's tougher stance on both anti-money laundering enforcement and restrictions stemming from capital flight concerns. Last year, the Committee on Foreign Investment in the United States introduced new legislation that puts certain real estate investments by foreign entities under potential regulatory review – not necessarily a deal-breaker but enough to put some foreign investors at a disadvantage during the bidding process.

Then there are market dynamics with which to contend. Property prices in the U.S. have reached the point where it is becoming increasingly difficult to generate required levels of return, particularly after management fees are taken into account. The turbulence caused by Brexit and other disruptions has created a wider range of viable investment alternatives elsewhere. Uncertainty over interest rates plus the unsettled political environment in Washington do not help.

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But as is common, there are those who see opportunity in challenge. In the last several years, we've seen the rise of a new generation of foreign investor. Often the second or third generation in their family firm, these investors are generally educated at top U.S. colleges and business schools, and their classmates now head development projects and run the acquisitions departments as sponsors. What's more, the education of these foreign investors typically happens to be in or near the secondary cities that have fostered dynamic real estate markets over the last decade, such as Raleigh-Durham, Austin, and Charlottesville. This combination of relationships and firsthand geographic knowledge has allowed these younger, highly sophisticated foreign investors to forge deals directly with sponsors and developers here, sidestepping the offshore sponsors that have been the traditional link between foreign capital and U.S. investment. It has also helped expand the options of foreign investors, who are moving with greater confidence into the development projects from which they have traditionally shied away.

Given this, we expect foreign investment to continue at a steady pace, with midmarket investors and family offices playing an increasingly important role in the capital mix. U.S. developers and sponsors should respond accordingly by courting these foreign investors more directly than they have in the past. Working back though the networks of their thirty-something executives is a good place to start. Doing so can solidify relationships with key sources of funding both now and for the future.

# MULTIFAMILY REAL ESTATE OUTLOOK REMAINS POSITIVE

Last year, the multifamily sector continued the remarkable run that helped spearhead the recovery of the commercial real estate sector after the global financial crisis. As we've moved into 2019, many of the underlying positive forces remain. There is still considerable opportunity to be found in building properties targeted to millennials and empty nesters. While some millennials have shifted into homebuying, lingering student debt and upward pressure on interest rates continue to put homeownership out of reach for many. For them, amenity-filled apartment buildings in urban work/play/live areas or suburban transit hubs offer an alternative American dream. Indeed, the communal living spaces cropping up in major urban areas are merely the logical extension of a long-running trend in which personal square footage takes a back seat to extensive common areas. The long-term staying power of this shift remains to be seen but bears close watching, given changing norms of ownership in everything from transportation to workspace.

This year will see a large swath of new multifamily projects exit construction and come online; starting next year, we expect construction to slow as traditional lenders — already conservative on construction — further pump the breaks on financing. The many private equity and institutional investors that still want to participate in the multifamily market will continue to push into new avenues for doing so, such as senior housing and age-restricted developments. Workforce housing, which has struggled for attention in recent years, may become an attractive way for investors to enter (or strengthen their holdings in) otherwise pricy secondary markets.

One trend that we expect to see continue applies multifamily investment strategies to single-family homes, with private equity firms and hedge funds acquiring tens of thousands of single-family homes as rental properties; the rental income becomes a securitized asset that can be offered on the secondary market, giving rise to single-family rental REITs. While still a small asset class, it has begun to reach critical mass and develop its own following among investors.

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# STRATEGY FOR TODAY'S COMPLEX HOMEBUILDING MARKET

Today's housing market poses a number of risks for homebuilders, but the current environment also creates opportunities for those who can find them. Large builders are leveraging their economies of scale and access to lower-cost capital to generate additional market share at the expense of smaller competitors, who are responding by creating and exploiting expertise in niche segments of their markets.

## Today's challenges

The challenges facing builders start with construction costs, which are rising at a much higher rate than inflation, fueled by tariffs on steel, aluminum, lumber, and other core housing materials. A second hurdle comes from obtaining finished residential lots, which can account for as much as 20 to 40 percent of the total building cost, depending on location. The cost of those lots has grown in tandem with the underlying compliance costs of local building and zoning regulations, which can add up to 25 percent of the cost of a typical single-family home. Infrastructure costs, county fees, entitlement fees, and so on also have increased, with permits sometimes costing more than $100,000. All this has resulted in a dearth of finished lots, while making those lots that are available substantially more expensive.

## First-time buyers seek shelter but are price sensitive

Rising building costs have made it challenging for the industry to profitably produce more affordable homes – precisely the ones most in demand by millennials, many of whom are now starting families. But while builders are counting on millennials to drive growth, and while more millennials are purchasing, they're also highly price sensitive. Having seen from their parents where financial overreach can lead, this cohort has developed a great deal of financial discipline and a practical, no-nonsense mindset. As first-time buyers, they are seeking a place to live rather than the aspirational homes in which they grew up. (Their empty-nester parents, of course, make up the second notable homebuying cohort – but they bring their own challenges, including numerous demands that often slow the closing of the deal.)

## Numerous options to achieve profitability

The first priority for many builders then is to find the locations where they can walk this tightrope and create an attractive product for first-time buyers while still turning a profit. Others, however, are turning to the growing market in single-family rentals. While the details vary with geography, single-family rentals generally allow developers to produce a profitable product in high demand, investors to generate strong returns, and residents to choose from a range of new and affordable housing options. Indeed, the opportunities in single-family rental now attract institutional private equity investors and their developer partners, who have replaced an earlier generation of mom-and-pop investors. Thoughtful residential land developers now are integrating neighborhoods of single-family rental residences into their master planned communities. In fact, entire communities of single-family rental housing are cropping up for those who can't afford to buy or are reluctant to do so.

In the current uncertain housing environment, resilience is key to long-term success for builders large and small. Builders need to address two critical questions: what could go wrong that could cause my company to fail, and how do I effectively compete and create value over the long term? Answering those questions can provide a strategy for growth amid today's opportunities and challenges.

# HOTELS

## As we reach the top of the market, preparing for what's next

The hotel sector has headed into 2019 with much of the same momentum as during the previous two years, with occupancy rates absorbing roughly the 2 to 2.5 percent annual growth in supply. The stamina of the current cycle validates the discipline that both lenders and brands imposed to keep development steady but in check. But the current equilibrium between supply and demand – combined with macroeconomic turbulence from relatively slow economic growth, conflicting signals on interest rates, and a divided government presiding over a shutdown – signals that the sector may well be nearing the end of the dramatic expansion of the last several years.

**Now is the time to look at properties with a critical eye to ensure that they are operating with maximum efficiency and are poised to be on the strongest possible footing for whatever conditions develop. This strategic audit should include having a clear sense of the market and customer base.**

With that turbulence on the horizon, hotel owners should focus on scrutinizing their operations, making it a top priority for the first half of 2019. When times are flush, it's easy to let inventory cost control become less stringent and workforce numbers creep up. Now is the time to look at properties with a critical eye to ensure that they are operating with maximum efficiency and are poised to be on the strongest possible footing for whatever conditions develop. This strategic audit should include having a clear sense of the market and customer base. For while macroeconomic conditions set the overall business environment, success in the hotel industry depends on local factors – including having a solid revenue management team, a clear value proposition, and strong relationships with the local community.

Ensuring that the house is in order also makes the property more attractive to potential buyers. With the market cresting, some owners may decide this is the time to take some money off the table – or at least test the waters. In that case, an operational review should be accompanied

by a close examination of the property's finances, as well as its internal controls and reporting systems so that due diligence can be responded to quickly and confidently.

Most owners, of course, will elect to hold their properties; downturns are an inevitable part of the business. So is refinancing. Banks and institutional investors provide a baseline level of funding, but filling the remaining equity gap is the real test of the ability to manage the capital stack. Over the last year, we have helped facilitate several refinancings involving family offices. Unlike institutional investor fund managers, who tend toward specialization and proven formulas, family offices often have an entrepreneurial, opportunistic mindset and a longer-term time horizon, making them attractive investment partners for this dynamic asset class. However, that entrepreneurial and opportunistic approach also means that they are likely to have less hotel-specific experience and more questions than other investors – particularly as they come to appreciate that real estate is only one facet of a hotel investment. Owners and developers may thus find themselves giving master classes on the many moving parts that contribute to a property's bottom line. And while family offices might be willing to invest with longer-term horizons, they will still want to see a clear exit strategy. Owners and developers who are willing to put in some extra effort, however, are likely to be rewarded with long-term – and highly networked – financial partners.

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# ABOUT COHNREZNICK'S REAL ESTATE INDUSTRY PRACTICE

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# ABOUT COHNREZNICK

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