Winter 2016

REAL ESTATE INSIGHTS

Top 2016 Resolutions for REITs

For many, New Year's resolutions serve as an annual clean slate, offering an opportunity to overhaul habits and focus on getting healthy once and for all. The all-too-familiar problem, though, is that oftentimes, these resolutions are abandoned before the winter snow melts. This year, there are a few resolutions REITs can make—and, more importantly, keep—to start off the new year on the right foot, get their balance sheets healthy and power through 2016:

Reduce reliance on low-rate debt.
Many analysts predict that near-zero interest rates could soon be a thing of the past. With a strong chance that the Federal Reserve will raise short-term interest rates by the end of this year, REITs should take advantage of low rates and consider accelerated refinancing in order to lock in favorable rates before the current cycle of low interest rates ends. As higher yield investments, REITs can experience more sensitivity to interest rate changes than some other investment classes. REITs should address their reliance on low-rate debt when building 2016 expansion plans, as higher interest rates will mean increased costs on financing for new properties and refinancing of existing debt.

Diversify portfolios to reduce risk.
As REITs answer market demands for clearly communicated and focused strategy, some are choosing to diversify to minimize risk and encourage greater risk-adjusted returns over time. And more REITs are diversifying: according to REIT.com, the number of diversified REITs has nearly doubled since 1999. However, even companies that have a diversified mix of assets are smart to choose a regional portfolio focus to maintain a unique value proposition and control exposure to concentrations in markets with less upside potential. A smart diversification strategy, whether by property type or location, is considered essential in maximizing shareholder returns over the long term.

Monetize assets in more mature markets.
To stay ahead of the herd, REITs might consider monetizing their assets in gateway markets, many of which are slowing, in pursuit of a portfolio focused on emerging markets with high growth potential, like Austin, Texas, and Savannah, Ga. Strategically selling some assets in larger, more established markets like New York or Chicago will free up capital, allowing REITs to pursue deals in secondary markets that might be at an earlier point in the growth cycle and ultimately might provide a better return.

Enhance transparency and due diligence.
Smart REITs will work to strengthen communications with key stakeholders around performance and business risks to ensure nothing is overlooked in the development and implementation of the new year's business strategy. High standards of due diligence and increased transparency around risks and outcomes will help REITs continue to thrive in 2016 and beyond.

Anthony La Malfa is a Partner with BDO's Real Estate and Hospitality Services group.

Compensation Trends for Real Estate CEOs and CFOs

Real estate industry CEOs and CFOs were the highest paid across eight major industry sectors during 2014, according to The BDO 600 CEO and CFO Pay Study. Last year, real estate CEOs and CFOs were the second most compensated, falling right behind executive leaders from the energy sector. The analysis was conducted by BDO's dedicated Executive & HR Practice, and examined proxy statements of public real estate companies with annual revenues between $25 million to $1 billion.

This number one ranking could be attributed to the positive economic climate during 2014 and an increase in overall business. It could also be due to real estate CEOs' and CFOs' growing role and the increased complexity of the real estate industry, which now necessitates not only an understanding of their industry, but how advancements in other sectors, like technology, are significantly impacting their business. Another factor possibly contributing to the ranking is the sophistication required to navigate the changing debt and equity markets, which saw significant swings for real estate companies.

While the real estate sector comprises the highest compensated executives, real estate CEOs did experience a 1 percent decline to $4,515,764, from $4,553,611. Average real estate CFO compensation, however, increased to $1,818,693, an 8 percent year-over-year increase. This disparity between real estate CEO and CFO pay was in alignment with the study's overall finding that in 2014 CFO year-over-year compensation outpaced that of the CEO.

According to Randy Ramirez, a senior director in the Global Employer Practice at BDO, "There is clearly a sense of cautious optimism when it comes to the economy given its skittish performance and high volatility. Because of this, CEO and CFO compensation is rising at a more measured pace when compared to last year."

Ramirez continued, "Companies also want to capitalize on bullish market days and, as a result, are incentivizing their executives to accelerate bottom-line growth and unlock greater shareholder value. CFO compensation, in particular, is benefiting as it outpaced CEO pay growth. One possible explanation is the increased responsibility placed on CFOs to leverage market momentum in order to realize a company's financial vision."

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Did You Know...

- Closed-end and private real estate funds raised $37.5 billion in Q3 2015, the largest amount ever raised in a single quarter, according to Preqin's Quarterly Real Estate Update.
- Construction employment grew by 31,000 in October, to 6.43 million, and by 233,000 over 12 months, according to Bureau of Labor Statistics data.
- Urban Land Institute's Real Estate Consensus Forecast projects hotel revenue per available room to grow 7.9 percent in 2015, 5.9 percent in 2016 and 4.2 percent in 2017.
- The apartment and condominium market experienced its 15th consecutive quarter of growth conditions in Q3 2015, according to the National Association of Home Builders' Multifamily Production Index.
- Real Estate CEOs/CFOs are the highest paid in the business world, according to the BDO 600 CEO and CFO Pay Study, with average compensation at $4,515,764 and $1,818,693, respectively.
- According to Commercial Property Executive's CPE 100 Quarterly Sentiment Survey, 78 percent of executives surveyed named secondary markets as the category that will attract the biggest increase in investor interest during the next 12-18 months.
- The office sector has enjoyed a solid increase in demand in 2015, with net absorption up 30 percent year-to-date from last year, according to NAREIT's Q3 2015 Commercial Property Update.

Perspective in Real Estate

Deal activity in the commercial real estate sector is growing amid soaring property values and an increased appetite for risk, according to the Wall Street Journal. While many post-crisis investments have focused on core properties—fully leased buildings—some investors are now looking for funds that buy into new developments and other riskier assets, often looking for 20 percent yield or more. Morgan Stanley, hit especially hard by the last housing crisis, recently raised a $1.7 billion higher risk fund, marking a recovery from the downturn, the Journal reports.

Among residential real estate acquisitions, private equity is increasingly replacing developers in deals for large buildings and apartment complexes, especially in New York, according to Fortune. Blackstone Group—the world's largest private equity real estate investor—recently made a major push into multifamily apartment holdings with its $5.3 billion acquisition of Manhattan's largest apartment complex, Stuyvesant Town-Peter Cooper Village. Blackstone's CEO Steve Schwarzman predicts "core" properties such as this may eventually make up $100 billion in assets for the firm, according to Bloomberg. Turning to apartments later than some of its peers, Blackstone has acquired 46,000 units over the last two years, Bloomberg reports.

Blackstone's largest real estate deal in 2015 was its $23 billion acquisition of a portfolio of properties from General Electric. In addition to significant new investments, the PE firm has also returned $25 billion to investors from property sales since September last year, more than half of its total realizations of $45 billion for the same period, according to Bloomberg.

The hospitality sector is in the middle of a consolidation boom, as hotel brands look to boost their profits, add hotel rooms and grow their geographical footprint before the peak of the growth cycle, according to the Financial Times. Marriott International has announced it will buy Starwood Hotels in a deal valued at $12.2 billion, creating the world's largest hotel company, and French hotel group Accor looks set to buy FRHI Hotels and Resorts for $3 billion. While some hotel chains have sufficient cash for new acquisitions, they face stiff and growing competition from Chinese investors, who are expected to buy some $5 billion worth of hotel assets this year, the Financial Times reports.

This M&A boom also presents exit opportunities for PE firms. For example, Goldman Sachs, Avenue Capital and GoldenTree Asset Management are considering a sale of U.K. budget hotel group Travelodge, Carlyle Group is looking to sell its 80 percent stake in French budget chain B&B Hotel Group, and Lone Star has put its Atlas Hotels portfolio up for sale.

There are opportunities for private equity firms in every corner of the real estate market. However, real estate funds should expect increased regulatory scrutiny in the coming year. Blackstone and KKR both paid multimillion-dollar settlements in 2015 over allegations that they did not properly disclose to investors special fee arrangements, discounts and waived "broken-deal" expenses that benefited certain investors, including company executives. In 2016, real estate funds can expect heightened SEC oversight of their business relationships, particularly over the potential hiring of businesses they control to do work for their portfolio companies, according to SEC Chair Mary Jo White.

PErspective in Real Estate is a feature examining private equity investment in the real estate sector.