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Partners At the Helm

Reznick Group is steering clients through a shifting tax, accounting and regulatory landscape

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COVER STORY



From left: David Kessler, chair, National Commercial Real Estate Practice; Scott Farb, chair, National Real Estate Committee; Tim Kemper, regional managing principal, South; and Brent Solomon, principal, Valuation and Transaction Advisory Group.

The principals of the Reznick Group are working hand-in-hand with C-suite executives to guide them through the ever-changing regulatory, tax and accounting environment

Partners at the Helm

By Sule Aygoren Carranza

Clearly, the real estate landscape hasn't gotten any easier to navigate over the past several years. As if the overall economic downturn and capital crisis weren't enough to deal with, changes to accounting and tax rules add another layer of complexity to doing business.

"The plethora of new rules and regulations have a substantial impact on the accounting, tax and regulatory sides of the business," says Scott Farb, chairman of the National Real Estate Committee for the Reznick Group. "There's been significant legislation that will have an impact on financial reporting; I don't even think it's all been completely analyzed. Even the accounting rules are getting so complicated and changing so fast that companies are having a very difficult time keeping up and complying with all the changes."

The rules of the game have changed dramatically, maintains Brent Solomon, the principal in charge of the Century City, CA-based firm's Valuation and Transaction Advisory Group. And they've changed in a way that puts greater pressure on those analyzing deals and firms' books. "Hiding a problem because a property is purchased and reported at cost is not an option anymore," he says. "There's more emphasis on due diligence and ensuring a complete evaluation of the asset and local economic conditions are done."

Some critics say the changes are making the markets too complicated and are occurring too quickly for anyone to keep up. "It's a new world in terms of the pace and depth of change," comments Michael Beck, an audit principal in Reznick's Atlanta office. "The FASB was even asked to slow down because of the market's inability to accurately consider their impact and implement them. There's a limit on how fast those changes can be put into place."

For instance, he notes, FASB is currently examining the issue of revenue recognition, which would impose one standard across all industries. "When you change how people account for things at their root cause, you impact their processes and controls," says Beck. "All their controls have to have one goal, which is to create accurate financial reporting. There are big companies out there with lots of subsidiaries and lines of business that would all have to be brought into conformity with the new rules."

Better or worse, these changes are happening—rapidly. So how does the industry keep up? That's where a dedicated consulting firm comes in. Previously brought in to consult primarily on tax and accounting issues, CPA firms like Reznick have become an invaluable resource for industry players who need help staying abreast of the evolving regulatory environment.

Take an instance last year in which New York City-based fund management firm Dune Real Estate Partners enlisted Reznick to work on an industrial deal in Florida. Dune's operating partner at the time was not familiar with Reznick, says Dune's CFO, Darren Berk. But the firm "demonstrated their responsiveness" and comfort "in the space," he says. "We wanted to hit certain deadlines shortly after year-end, and their commitment, resources and capacity to complete their process within 60 days of year-end was presented in a crisp and efficient manner."

Since that first experience with Reznick, Dune has further integrated the firm into the mix of providers it uses for accounting, audit, tax and consulting services. In fact, Reznick is currently working on three projects for Dune's fund business.

Kevin Staley, principal and co-founder of the Los Angeles-based Magellan Group, another Reznick client, clearly believes in consulting firms. "It's critical to stay current on the complex



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MICHAEL BECK
AUDIT PRINCIPAL

new issues,” he says. “It’s important for your advisors to remain up to speed on what’s happening in the industry to give you sound and clear advice.”

The impact these changes are having are not only deep, but widespread. Take, for instance, the proposed changes to carried interest, requiring service providers who would normally take income as a capital gain to instead get charged ordinary income. The details, including the ultimate percentage hit, are still being hammered out.

But a tax advisor can stem that bloodletting. There are loopholes, says Greg Bloomberg, a tax accounting principal at Reznick. “We can try to get it characterized as a capital interest as opposed to a carried interest by contributing some capital,” he relates.

It’s also an opportune time for individual investors to plan ahead. Next year, the estate tax goes back to the 2001 rate. “It’s caught everyone’s attention,” says Solomon. “Many clients say the political environment plus the expectation that values are bottoming make this an opportune time to effectuate estate-planning strategies, which generally include transferring minority ownership interests to either family members or trusts. Obviously, the lower that value, the better it is for the strategy.”

Reznick’s real estate practice works with the entire spectrum of players, including developers, owners, property and asset managers, lenders and state and federal agencies. Farb breaks down the firm’s client base into two categories—the healthy and the not—and what those firms are looking for from a consulting firm varies.

“The healthy ones have few, if any, legacy assets,” he says, “as well as the liquidity to borrow or refinance at low rates. These firms generally need services relating to asset acquisition, such as auditing, tax preparation and acquisition analysis, both on the financial side and tax side. “They’re the ones forming new entities and doing more deals, and that keeps us busy in compliance-services,” he notes.

These clients tend to be on the capital side of the market, flush with capital and able to maintain liquidity. But that doesn’t mean they don’t have issues. “Although they have the capital, a lot of them are going through a paradigm change,” says Farb. “They’re having unprecedented issues such as meeting investor return expectations in a low-leverage environment, fundraising challenges, legacy issues and trouble restructuring and acquiring. So, even though they have the capital, they still face significant unprecedented challenges.”

Then there are the companies with highly leveraged portfolios that have declined in value, who may have to sell assets or pay down loans. These less financially sound clients “are in crisis-management mode,” says Farb. “They’re looking to increase their liquidity, refinance existing debt, leverage unencumbered assets or just manage their own cash flow and control their costs.” These companies, the bulk of which are on the operating and development side of the business, tend to need services related to cash-flow monitoring.

There is one service area utilized by nearly all the firm’s clients: valuation. With values down as much as 60% from their 2007 peaks, Reznick has been called on to provide financial reporting and

appraisal services for everyone from property investors to lenders. Like most consulting groups, Reznick’s real estate group has experienced about 50% growth this year, says Solomon. “Part of the reason that we are able to have growth in our group is because of how broad the application of our services are,” he says.

Over the past several years, the approach to valuing an asset has shifted so that it’s now based more on its fair value, rather than cost. Not only are there new factors to take into consideration, but with a lack of comparable sales and diminished property performance, it’s enough to cause confusion. “Fair value complicates my world substantially,” admits Solomon. “It’s a concern among auditors and companies reporting their real estate values.”

In general there are three methods of appraisal—the market approach, based on comps; the income approach, using expected cash flow from the asset; and the cost approach, reliable only for new properties. The small number of deals has shrunk the comparison pool considerably, causing assessors to cast their net wider to get a good sampling. “Even if you find them, we have to make sure that we understand if there were special terms involved, if it was a distressed transaction or if they provide data that’s relevant,” says Solomon.

And if determining fair value weren’t difficult enough, auditing it is much trickier. Because it’s so difficult to obtain reliable market data, Beck says, “when you come up with an estimated value, it’s based on management’s assumptions. It’s made the process more difficult because the implications can be difficult, if not devastating, since you’re taking huge losses.”

From an auditor’s perspective, there are two different but equally important concerns in valuation. First is whether there’s an impairment on the property. If so, it needs to go through the fair-value measurement process, explains Beck. “Auditing fair value is very different than determining it,” he says. “Auditing it involves looking at what the client did. Is it reasonable? Has it been properly



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GREGG BLOOMBERG
PRINCIPAL, TAX ACCOUNTING

adjusted for the unique characteristics of the real estate?

“Real estate in particular is difficult because no matter what anybody says its worth, they’re estimating that the amount you get when you close is fair value,” Beck continues. “It’s a losing argument for auditors to say, ‘This is the value,’ when you’re always going to be wrong. We’re trying to figure out what a buyer would value the property at, and the owner is always looking at it through what their own assumptions are. Those don’t match up often.”

And then there’s testing the property for impairment, or seeing if the fair value is lower than the carrying cost. The first step is to determine if there are any triggering events that would warrant a test. Today, anything from economic and market conditions to a lease rollover could qualify as such. Step two is the recoverability test, which gauges if the undiscounted cash flows will allow the owner to recover its carrying costs.

If neither of those tests are met, the auditor turns to the fair-value process. This is where the various approaches to fair-value

determination come into play. With the difficulty in using comps, “income approaches are almost always used in commercial real estate, and that’s generally going to include either a capitalization-of-income method or a discounted-cash-flow method,” says Solomon. “Not so long ago, we used to get a rent roll that indicated the lease terms for all of the tenants. There was no reason to believe that that rent roll wasn’t legitimate. Today, our discussions turn immediately to where the owners are in the process of potential lease negotiations.”

And if an asset is being held for use—that is, you’re trying to recover its carrying value through use as opposed to a sale—you’d have to record the impairment only if you don’t recover its carrying value through use, i.e., the cash flow. Properties that are operating, says Beck, “may have plenty of current lease revenue to show that they can be recovered. They don’t have to record impairment.”

The problem with impairment adjustments is that they’re not reversible; once the write-down occurs, there’s a new cost basis. “It’s a technical area, and a lot of clients have a hard time understanding the nuances,” says Beck. “Most are more focused on the impact, and I don’t blame them. It’s talking about survival.”

To shake things up more, now there are potential changes to the lease accounting rules. These would have the greatest impact on clients that hold assets for eventual sale, since they would require the liability for operating leases to be held on the books as an asset. Also on the owner side, another project the FASB has under way involves accounting for investment property.

The agency is deciding if investors should go to a required presentation at fair value. “That would be a huge change since now, they’d have to obtain a fair value of properties annually,” says Beck. “Today, unless you’re an investment fund, it’s not a requirement.”

Not surprisingly, the market discord has also led to a rise in litigation; Reznick partners constantly take the stand as expert witnesses. “It’s the one area where there’s probably a lot more activity, because there’s a lot of disgruntled investors,” says Farb. Similarly, Reznick’s real estate group handles forensic accounting for lenders and borrowers, reviewing the books, records and transactions for the plaintiff or defendant to see just where a deal went wrong.

The feeling that the market is reaching bottom has sped up the dispute and litigation arena. “It’s almost counterintuitive,” says Solomon, “but a lot of times our clients are making a cost-benefit decision as to whether to proceed with litigation. It doesn’t necessarily hold true that in bad times, people will litigate more.”

With as much as \$4 trillion in debt expected to come due over the next several months, it’s almost guaranteed that litigation will rise. So will the need for workout, modification and restructuring services.

At Reznick, some of the partners who focus on workouts and the restructuring of distressed assets are David Kessler, co-managing principal of Reznick’s Bethesda, MD office and chair of the firm’s National Commercial Real Estate Practice, and Jim Vincent, senior managing director of Reznick’s Restructuring Solutions Group. They say the sophistication of and lack of clarity in the markets, combined with the increased complexity of CMBS loans and weak capital-market conditions have made their roles much more difficult.

“Had the capital markets been more robust, people’s views about possible workout solutions would have been clearer,” says Vincent. “In the absence of that, people have been stalled. Had this cycle occurred five years ago and there was depth in the capital markets for a takeover, you would have pushed through a lot of these issues faster.”

Their main concern, Vincent and Kessler say, is to understand each of their clients’ situations, their different sensitivities and help them think through various alternative solutions that are available to them. Usually the most viable option results in all parties taking a little pain, and some element of new capitalization. “If you don’t know the major pressure points for the particular parties—and in some cases there

may be legal restrictions or limits, or REMIC rules on the CMBS side, for example, that just prohibit certain things to happen—you can’t effectively negotiate or advise your clients on what they can achieve,” says Vincent.

Frankly, he adds, the various rules and nuances to the lending market are enough to dishearten any borrower. The rules around REMIC requirements, what might prompt certain servicers to take one workout strategy over another, rules about what’s permissible inside a CMBS trust—all of those must be considered when working out loans. “That’s a big difference for a borrower, and they get flummoxed because they don’t know who to reach out to,” says Vincent.

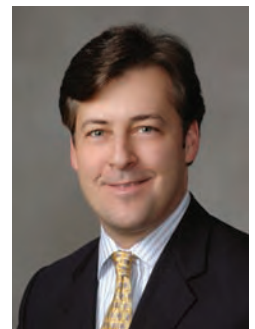
While they also engage with lenders, a bulk of the firm’s work is for its borrower clients. And, in most cases, working out a solution with the lender is the best option for all parties; if the borrower is managing the property well and has basically been holding up its end of the deal, there’s little reason to go through the foreclosure process.

For investors considering distressed assets, there are also opportunities for investors to benefit from a workout. That’s what Farb sees as a good bet in the short to medium term. “The real opportunities are going to be those where the investor can get to the owners of these assets before they default on their loan obligations,” he says. In this, there are several options—recapitalizing a company or deal, buying the existing loan from the borrower, refinancing the loan, or buying the property at a distressed price and paying off the debt.

Regardless of how many workout and capital restructuring options there are, however, they won’t be enough to get a handle on all of the distress. Assets in the foreclosure process already exceed \$150 billion,

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JIM VINCENT
SENIOR MANAGING DIRECTOR,
RESTRUCTURING SOLUTIONS



says Farb, and on the CMBS side, the delinquency rate already exceeds 9%. “A lot of capital is lined up to take advantage of what could be a very active transaction market,” he relates. “Sales volume in the second quarter jumped by over 32% because there’s finally movement by banks and borrowers in disposing of assets.”

And the FASB is currently considering a rule change that may cause a flood of distressed assets to break free of banks’ balance sheets. In an exposure draft, the FASB proposed expanding fair-value accounting rules so they would apply to all financial instruments, including real estate loans. In effect, this would force banks to write down all of their assets. While the jury is out on which way it will go, says Solomon, “if that rule were implemented, it might speed up the resolution process because the banks would have to take losses by marking their loans to market. If that happens, extend and pretend will be much more difficult to continue.”

And that’s when the opportunities will really open up, and for all market participants. “We have 1,000 people involved in every aspect of real estate, whether it’s on the borrower, lender, developer or fund side,” says Kessler. “Every day we’re helping clients figure out how to capitalize off of things. We’re helping everybody, on all sides.” ♦