

Real Estate *advisor*

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When it's time to re-evaluate investments, get a valuation

The master lease: An umbrella of protection

IRS makes it easier to deduct
real estate activity losses

Ask the Advisor

Should I use specialty leasing to increase ancillary revenue?

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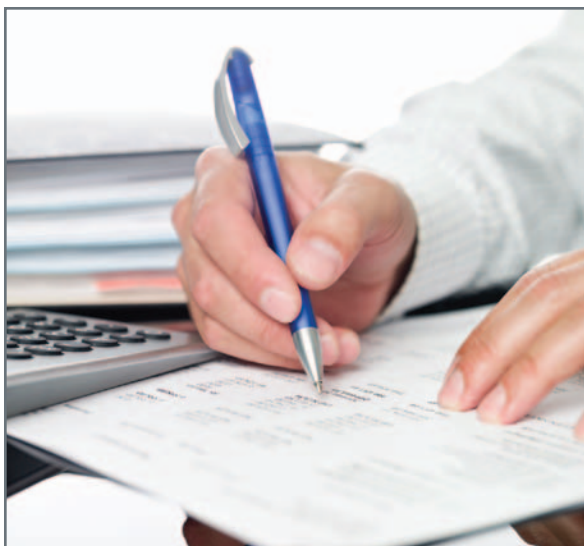
When it's time to re-evaluate investments, get a valuation

As you know, the recession has taken its toll on real estate markets. Commercial property values are down for many reasons, and most owners and investors understand this. But if you're reconsidering the right path forward — with possibilities ranging from staying the course to teardowns to surrendering to the bank — you need more than just a general sense of decreased value. A formal valuation can help you chart the best course of action.

The critical valuation factors

Income-producing properties are usually valued using the income approach. It recognizes that investors purchase these properties for the income stream they'll produce in addition to their appreciation in value over time.

Under the income approach, a property's value is calculated by dividing its net operating income (NOI) by the capitalization rate. NOI is determined by estimating income and deducting both operating expenses (net of recoveries) and an allowance for vacancy and collection loss.



Operating expenses typically exclude capital expenditures, depreciation and mortgage payments. Historic operating costs may need to be adjusted to reflect typical operating conditions, especially if management has deferred repairs or related parties are involved.

In a survey of commercial real estate professionals conducted last year by FTI Consulting, respondents were asked which risk factors present the greatest risk to future real estate values. Almost half identified market condition changes that affect NOI as the most significant risk to values.

The real NOI

Market conditions such as rising vacancies and falling rents mean a property's NOI, and its value, will likely decline. But it's tricky to figure out how those conditions affect a particular property's value.

For valuation purposes, market vacancy rates in a stable market are typically calculated by dividing the number of vacant rental units in a property by the total number of rentable units or the amount of unoccupied square footage by total square footage. The problem is that market vacancy rates today, in an unstable market, can't always be taken at face value. Consider the following:

Incentives. With landlords competing fiercely for tenants, many engage in tactics that can inadvertently make their market vacancy rates deceptive. For example, if several tenants sign long-term leases based on receiving a six-month rent-free period, from a market perspective a property can be 100% occupied, but from an economic perspective those units are no help to the NOI during the incentive period (and may actually hurt it if unrecovered expenses associated

with the units outweigh expenses associated with marketing empty units).

Landlords are reducing their NOI with other incentives, too. Some offer furniture or moving allowances, which can increase expenses. Tenants have also negotiated lower rents in exchange for funding leasehold improvements that landlords can't provide due to lack of cash and access to financing.

Square footage. When units are vacant, the market vacancy rate can be less than the economic vacancy rate. Consider a building with 30,000 total square feet and potential annual income of \$400,000. If several units representing 3,000 square feet of the building's physical space are vacant, the market vacancy rate generally would be 10% (3,000/30,000).

That figure doesn't necessarily reflect the economic loss associated with the vacancy, though. If those units would produce \$48,000 in rent if occupied, the economic vacancy rate is 12% (\$48,000/\$400,000). Relying on the market vacancy rate when determining NOI would overstate value in this hypothetical example.

The cap rate factor

Shrinking NOI isn't the only issue. Increasing cap rates have the same effect. Although interest rates on loans have dropped, debt funding has become scarce, forcing investors to rely more on equity financing. And equity rates have climbed as gun-shy investors require a higher return in light of perceived risk in the commercial real estate market.

Appraisers must be diligent when quantifying the cap rate, because small changes can mean dramatic differences in value. A qualified appraiser will customize a cap rate for the property that's supported by empirical data, including recent sales of local comparables. Appraisers impute a cap rate from a comparable transaction by dividing the property's NOI by its selling price. Together, a sample of relevant comparables can

The silver lining of decreased values

Declining property values aren't *all* bad news. Documented drops in value can help you reduce expenses for property insurance and taxes.

Property insurance premiums are based largely on a property's value. If current premiums reflect outdated, inflated valuations, your properties may be insured for more than they're worth. If you need to file a claim, it's likely that the insurer will determine its payout using the more recent, reduced value, so there's no point in paying the higher premium.

Similarly, you may be able to reduce property taxes by arguing that they're based on inflated assessed values. Few taxing authorities conduct formal appraisals of properties annually, so it's possible your taxes are based on the higher market values of a few years ago.



be a powerful tool for estimating an investment's cap rate.

The bottom line

Economic uncertainty has prompted many owners and investors to re-evaluate their investments. A real estate appraiser can provide an up-to-date valuation that allows you to make the best business decisions. ■

The master lease: An umbrella of protection

In a sluggish economy, you must fortify your interests and properties so you come out on top once the economy rebounds. A master lease not only can help you protect your properties, but also can lessen the possibility of rent defaults. Sound interesting?

What it is and how it works

A master lease covers a multitude of properties or units, with a single party assuming the role of master tenant and guaranteeing the rent for all the units or properties for the lease period. The master tenant should, of course, be a creditworthy party. Often, he or she is a close business associate, giving the owner assurance that rental dollars are in good hands.

Lenders like master leases because they offer an extra layer of protection against loan default.

The master tenant's rent guarantee protects the owner against rental market hazards such as vacancies and lease expirations, ensuring a consistent rental stream for the lease period.

Why it's a safer bet

Lenders like master leases because they offer an extra layer of protection against loan default. A master tenant is typically chosen for his or her pristine credit, making the person a safer bet than tenants whose credit may be less than perfect.

Lenders sometimes require a master lease as additional loan collateral. Master leases are especially common during the rent-up phase of a large commercial property or when an owner lacks



sufficient collateral or operating track record to qualify for debt financing. If an owner defaults on a loan, the lender looks to the master tenant as a secondary source of recovery after it's foreclosed on the property. The new landlord can then seek to collect rent payments due under the master lease.

Adding up the pluses

Why would anyone cast him- or herself as a master tenant, considering the responsibilities of the role? It's simple: profit. The master tenant, in effect, sublets the units the lease encompasses and becomes a stand-in landlord or property manager. He or she collects rent from subtenants and, after paying the master rent to the owner, retains all additional sums.

In addition, his or her liability is limited to the amount of the rent under the master lease — rather than the entire debt burden the property owner assumes.

Why lease structure is critical

You can structure a master lease such that you're ensured a guaranteed stream of master lease payments. Under a classic master lease structure, for

example, the entire project is leased by the master tenant, who then subleases units to subtenants.

Alternatively, you can limit the space covered by a master lease to only specific vacant space, or you may “float” the space to coincide with the spaces that actually become vacant during the master lease term. Some master leases terminate when space is leased to other tenants. Others cover units during a rent abatement period, when the occupying tenant pays no rent. Finally,

a master lease might take effect only when a lease nearing expiration isn’t renewed or the space is re-leased.

The “master” of leases

As a property owner, you must protect your interests and properties from whatever life — or the real estate market — throws at you. A master lease can help you not only decrease the risk of individual tenant defaults, but also build a steady rental stream. ■

IRS makes it easier to deduct real estate activity losses

Under recently released IRS Revenue Procedure 2011-34, real estate professionals can now more easily make late elections to treat all interests in rental real estate as a single rental real estate activity. What does this mean to you? The election can help you retroactively meet material participation requirements and deduct losses, potentially generating an income tax refund.

Why it matters

The Internal Revenue Code (IRC) generally allows you to claim passive-activity losses only against income from other passive activities. If your passive losses exceed your passive income for the year, you can carry the losses forward until you either have enough passive income to absorb them or you dispose of the activity, in which case you’re generally allowed to deduct the losses against nonpassive income.

“Passive activity” is defined as any trade or business in which the taxpayer doesn’t participate on a regular, continuous and substantial basis (also known as “material participation”). Rental real

estate activities are usually considered passive activities regardless of whether you materially participate — unless you qualify as a real estate professional. Then rental activities are treated as a trade or business, and losses from the activity aren’t considered passive, so you can deduct them against nonpassive income.

The stumbling block

A taxpayer qualifies as a real estate professional by satisfying two requirements. First, more than 50% of the personal services the taxpayer performs in trades or businesses must be performed in real property trades or businesses in which he or she materially participates. Second, during the tax year the taxpayer must perform more than 750 hours of services in real property trades or businesses in which he or she materially participates.

Under the IRC, a taxpayer’s interests in rental real estate generally will be treated as separate activities when determining whether the taxpayer materially participates in each rental real estate activity — unless he or she elects to treat all interests in rental real estate as a single rental real estate activity.

To make this election for a particular tax year, you must file a statement with specific information along with your income tax return. Taxpayers failing to make the election on their returns can seek an extension of up to six months by obtaining a letter ruling from the IRS.

The IRS has now outlined special procedures, in lieu of the burdensome letter ruling procedure, for obtaining the tax benefit despite not making a timely election.

However, this is a burdensome process. The taxpayer must, for example, file a “complete statement of facts and other information,” include copies of relevant documents, and provide an analysis of material facts and statements of authorities supporting and opposing the taxpayer’s position. The letter ruling request may also be subject to a user fee and a statute of limitations. After its review, the IRS may request additional information to make a determination. The process can take months from start to finish.

An easier way to make late elections effective

The IRS has now outlined special procedures, in lieu of the burdensome letter ruling procedure, for obtaining the tax benefit despite not making a timely election. To be eligible, a taxpayer must show the following:

1. He or she failed to make the election solely because of failure to timely meet the election requirements.
2. He or she filed consistent with having made an election on any return that would have been affected had the election been timely made — that is:
 - The returns must have been filed “as if” the election had been made on a timely basis,

- The taxpayer must have filed all required federal income tax returns consistent with the requested aggregation for all of the years under scrutiny, and
- Once the election is made, all future returns must be filed using aggregation unless the taxpayer no longer qualifies for aggregation or subsequently revokes the election.

3. He or she timely filed each return that would have been affected by the election if it had been timely made. (For these purposes, “timely” means that the return was filed within six months of the due date, excluding extensions.)
4. There is reasonable cause for the failure to meet the requirements for the election (for example, reasonable reliance on the written advice of the IRS).

The procedure contains specific requirements for requesting relief for late elections. For example, you must attach a specific statement to an amended return for the most recent tax year, and the statement must contain a particular declaration, explain the reason for failing to file a timely election, and include certain representations.

Making the election

If you haven’t made the election to treat all real estate activities as one activity, check with your tax advisor. If you’re in need of retroactive relief, he or she can help ensure that you satisfy all of the various requirements to potentially receive an income tax refund. ■



Ask the Advisor

Should I use specialty leasing to increase ancillary revenue?

As the economy continues to wobble along, many property owners are looking for creative alternative sources of revenue. Specialty leasing programs can provide a welcome revenue boost. But you need to know what you'll be getting into if you decide to take this route.

What is specialty leasing?

Specialty leasing encompasses a variety of arrangements for leasing nontraditional retail space. Lessees rent space for transportable “outlets” such as pushcarts and kiosks that sell smaller items requiring little or no preparation (think: cell phone accessories, jewelry or food). The arrangements typically include leases for both short and long terms. Some retailers — such as weekly farmers' markets or toy store outlets — may only sign seasonal leases.

Who are potential tenants?

As the concept of specialty leasing has gained popularity, nationally known retailers such as Sony, Apple, Tupperware and Avon are leasing carts and kiosks to sell their products. And they're not locating only in shopping centers — retailers and consumer product manufacturers who want to shorten their supply chains are also placing vending facilities in office buildings, grocery stores and other locations.



What programs work well?

The goal is to find tenants whose products will complement your existing inline tenants' offerings. With that in mind, you might offer retail merchandising unit (RMU) leasing in which you lease both space and an RMU (or push cart) to a business, retaining ownership of the RMU to ensure consistent design throughout your building. Kiosk leasing allows you to lease space to a business for a kiosk it owns. And if you choose vending, you'll lease space for cash-operated units that dispense a business's products.

What lease issues should I be aware of?

Before you enter into a specialty leasing arrangement, make sure it won't conflict with any existing leases. Some leases may prohibit the use of common areas for retail purposes. Future leases for traditional space should be negotiated accordingly. Tenants might request that you agree not to locate a specialty retail outlet within a particular zone (for example, within 100 feet of their storefronts) or not to locate competing specialty outlets nearby. Also run credit checks before agreeing to specialty lease terms. This is especially important for smaller lessees with unproven track records.

Explore the possibilities

Specialty leasing offers opportunities for shopping malls as well as for other types of commercial properties. Your financial advisor can crunch the numbers and help you determine the most lucrative specialty arrangements for your property. ■

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