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# 2013 BDO REITs RISKFACTOR REPORT

**CONTACT:**

**STUART EISENBERG**
New York
212-885-8431 / seisenberg@bdo.com

**MICHAEL BYRNES**
Philadelphia
215 940-7801 / mbyrnes@bdo.com

**BRENT HORAK**
Dallas
214-665-0661 / lhorak@bdo.com

**ALBERT LOPEZ**
Miami
305-381-8000 / alopez@bdo.com

**JOHN RAINIS**
Chicago
312-616-4644 / jrainis@bdo.com

**CHRISTOPHER TOWER**
Orange County
714-668-7320 / ctower@bdo.com

## IMPROVED ECONOMY BRINGS NEW RISKS INTO FOCUS FOR REITs

The ***2013 BDO RiskFactor Report for REITs*** examines the risk factors in the most recent 10-K filings of the largest 100 publicly traded U.S. real estate investment trusts; the factors are analyzed and ranked by order of frequency cited.

Recent reports have indicated that the real estate industry is poised for a turnaround, as the demand for new homes increases and confidence in the commercial real estate sector among economists and analysts improves. Emerging out of the economic crisis, the real estate industry sees new risks shift into focus – including concern over natural disasters, insurance and cybersecurity. While interest rates, competition, indebtedness and failure to qualify as a REIT continued to hold rank, risks related to tax laws and potential rate increases are on the rise.

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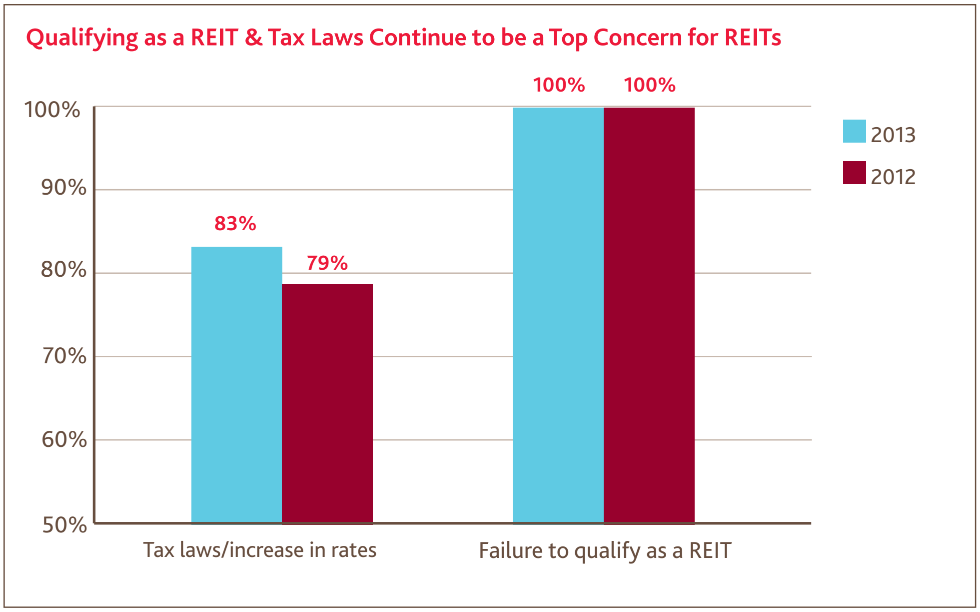
"For many years, lenders practiced prudence when it came to extending lines of credit to real estate investors," said **Stuart Eisenberg, partner and Real Estate practice leader at BDO USA, LLP.** "The confidence wasn't there and the conditions were such that it made it difficult to determine the right proportion of debt to equity financing. The current perception seems to be that the capital is there, and the new challenge is determining the best way to deploy it into strategic, favorable asset acquisitions."

## INDEBTEDNESS UNDERSCORES UNFAVORABLE PROPERTY PORTFOLIOS

Despite a slight decrease in the number of REITs citing indebtedness as a risk (85 percent, down from 90 percent last year), it continues to be a forefront issue for REITs that have portfolios comprised of properties with unfavorable loan to value ratios. Additionally, the decline in real estate values during the economic crisis resulted in an increase of asset impairment – a risk for just over two-thirds (70 percent) of the REITs analyzed in the study. The future value of a piece of property, however, is difficult to forecast, allowing for the opportunity for the loan to value ratios to favorably adjust over time. Concern over access to capital and financing also decreased by 3 percent, which could mean that the real estate industry has weathered the worst of the economic crisis and is turning a corner.

## LOW INTEREST RATES PROVIDE FAVORABLE, YET RISKY ENVIRONMENT FOR INVESTORS

The smart money continues to park its investable assets in REITs, as interest rates continue to trend near zero. Last year, the Federal Reserve planned to keep interest rates down until 2014 to promote borrowing. Their commitment to quantitative easing will likely continue beyond 2014 and impact rates until 2016. However, similar to last year, there is still no guarantee that interest rates will not rise before then, which could have a material impact on the overall real estate industry. This ongoing reassurance from the Federal Reserve to encourage a low interest rate environment could be leading to the slight decrease in REITs citing an increase in interest rates as a risk (88 percent this year, down from 92 percent).




## STRONG COMPETITION DRIVES CONCERN OVER ATTRACTING FINANCIALLY STABLE TENANTS

Strong competition for lessees and prime real estate is a top concern for the majority of REITs (96 percent, up from 93 percent). REITs are not only competing with traditional real estate developers, but also private equity firms that are acquiring single family homes to convert into rentals - a trend continuing from last year. However, as the housing market picks up, multi-family real estate could feel the squeeze from less demand for rental units, resulting in vacancies and oversupply. On the commercial real estate side, as businesses continue to practice conservative spending and some still bear the financial scars of the economic crisis, there is little surprise that three in four REITs cite the financial condition of tenants as a concern.

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## ▶INSURANCE LIABILITIES AND NATURAL DISASTERS POSE RISKS TO REITs

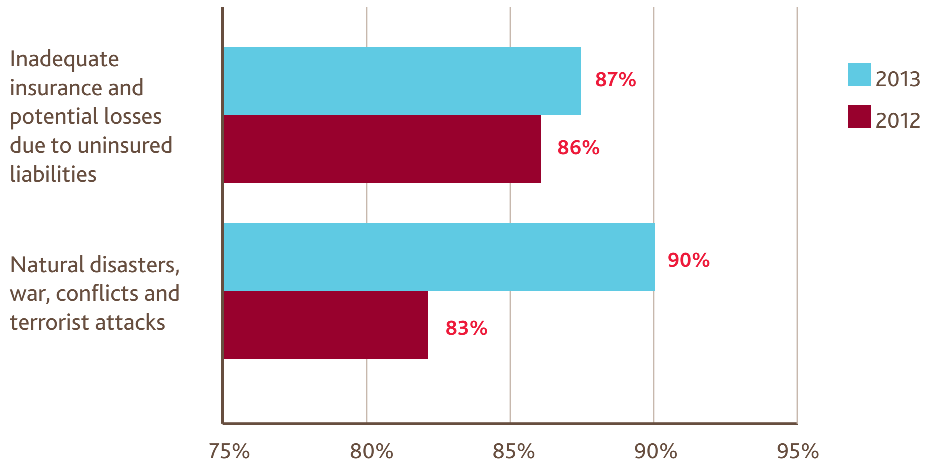
Recent natural disasters, such as Superstorm Sandy, resulted in long-term business interruption and either damaged or destroyed many coastal and low-lying properties. The losses with this storm and other significant weather events may be underscoring concerns over insurance. The risk of having inadequate insurance and potential losses due to uninsured liabilities continues to be cited by a large number of REITs (87 percent), while risks related to natural disasters, war, conflicts and terrorist attacks rose 8 percent from the previous year.

"Real estate entities rightfully have concerns over both inadequate insurance and natural disaster risks," said **Clark Schweers, managing director at BDO Consulting and head of the firm's Insurance Claim Services practice.** "During the financial crisis, these companies tightened financial spending and retained additional risk through cuts to insurance programs. In addition, we are seeing an apparent increase in the frequency and severity of natural disasters. This 'new normal' in weather patterns often places real estate company assets in the target zone for these events."

## ▶CYBERSECURITY INCREASINGLY DRAWS ATTENTION AS A KEY RISK

Data breaches have evolved into an almost ubiquitous business threat. From the risk posed by international and domestic hackers, to internal data security failures, sensitive and proprietary data may be in danger. As the potential loss resulting from a breach may expose REITs to a number of challenges, including liability claims, reputational damage and regulatory penalties, the number of REITs that cite security breaches as a concern jumped 56 percent this year (39 percent, up from 25 percent in 2012).

Insurance and Natural Disasters among Top Risks




**The Top 25 Risks for REITs**

| 2013 Rank | Risk Factor Cited in 10-K Filing | 2013 | 2012 |
|---|---|---|---|
| 1. | General economic conditions | 100% | 100% |
| 1t. | Failure to qualify as a REIT; Ability to make distributions | 100% | 100% |
| 3. | Strong competition for lessees and prime real estate | 96% | 93% |
| 4. | Inability to acquire capital or financing | 94% | 97% |
| 5. | Environmental liability | 90% | 91% |
| 5t. | Natural disasters, war, conflicts and terrorist attacks | 90% | 83% |
| 7. | Increases in interest rates; Hedging risks | 88% | 92% |
| 8. | Inadequate insurance and potential losses due to uninsured liabilities | 87% | 86% |
| 9. | Indebtedness | 85% | 90% |
| 9t. | Federal, state or local regulations | 85% | 94% |
| 11. | Tax laws and potential rates increases | 83% | 79% |
| 12. | Mergers and acquisitions, joint ventures and partnerships | 82% | 90% |
| 12t. | Inability to sell properties quickly | 82% | 89% |
| 14. | Anti-takeover and change of control provisions | 80% | 84% |
| 15. | Operating expenses and costs of capital improvements | 77% | 80% |
| 16. | Debt/financial covenant restrictions | 76% | 79% |
| 17. | Financial condition of tenants | 75% | 71% |
| 18. | Development and construction risks | 70% | 72% |
| 18t. | Declines or stagnation in business and real estate values; Asset impairment | 70% | 65% |
| 20. | Payments of common and preferred stock | 68% | 68% |
| 21. | Ability to attract and retain key personnel | 67% | 68% |
| 22. | Property foreclosure, bankruptcy | 65% | 37% |
| 23. | Volatility, seasonality/cyclicality of results | 50% | 57% |
| 24. | Working with third party management companies, vendors and developers in the U.S. or internationally | 44% | 43% |
| 25. | Security breaches | 39% | 25% |

*t – indicates a tie in the risk factor ranking

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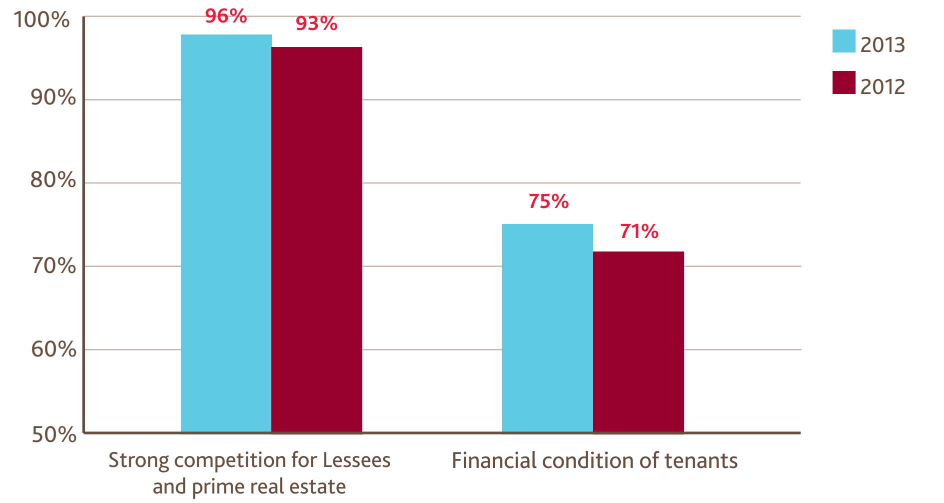
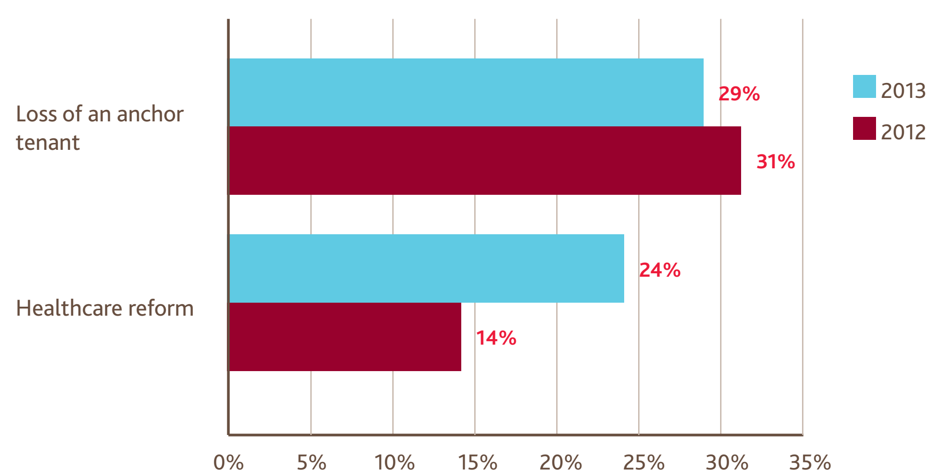
## ▶MICRO-REGULATORY POLICY MOVES INTO PURVIEW FOR THE HEALTHCARE REAL ESTATE INDUSTRY

Overall, only 85 percent of REITs are concerned about federal, state or local regulations – a decrease of 10 percent from the previous year. However, unique regulatory risks for the healthcare real estate industry have shifted into focus. While healthcare reform is not featured in the top 25 risks cited by REITs in this year's report, 24 percent of REITs note it as a risk – a 71 percent jump from 2012 (14 percent). Some of the largest REITs focus on healthcare, and many industry professionals have been predicting that this real estate sector will face significant growth, especially in the senior housing market that could be positively impacted by an aging population. Nevertheless, much of the growth is contingent on the impact of healthcare reform, which could result in a widespread cost-cutting environment from Medicare reimbursement cuts.

**Strong Competition Drives Concern over Tenant Liquidity**




**Retail Real Estate and Healthcare Real Estate Face Unique Risks**




## ▶RETAIL REAL ESTATE INDUSTRY STILL IN DEEP WATER, BUT OMNICHANNEL GROWTH COULD DRIVE CHANGE

A little under one-third (29 percent) of REITs cite the loss of a major anchor or tenant as a risk, compared to 31 percent last year. This very marginal decrease, however, may be an indication that the industry is stabilizing. The retail real estate industry suffered in recent years as consumer shopping shifted to online retailers and spending softened, and, while the industry may be far from reporting stellar profit margins, there is a strong indication that retail real estate will be a sector to watch, especially as retail companies practice omnichannel growth. For example, Piperlime.com (Gap's online-only fashion boutique) and Warby Parker both unveiled their first physical retail locations within the last 12 months.

*The RiskFactor Report for REITs* suggests that REITs face new, emerging challenges, despite the implications that overall market conditions are improving. Unfavorable loan to value ratios of portfolio properties continue to drive risks related to indebtedness, and interest rates, while still depressed, will eventually increase – possibly while nobody is watching. Moreover, healthcare reform poses an industry-specific threat to healthcare REITs, as it could usher in an era of unfavorable financial conditions for healthcare providers.

"Healthcare real estate continues to perform strongly, despite concern over policy changes. However, that is not to say that the industry isn't watching healthcare reform closely and considering what impact, if any, it will have on longer-term growth in the sector," said **Jeff Walraven, assurance partner in the Real Estate practice at BDO USA, LLP.**

## ABOUT THE REAL ESTATE PRACTICE OF BDO USA, LLP

With extensive industry knowledge, the partners and directors in BDO's Real Estate practice are value-driven advisors who offer accounting and tax experience in both the national and international commercial real estate arenas. The practice services a wide range of clients including middle-market real estate operating companies (REOCs), developers and real estate investment trusts, providing quality and timely guidance on major financial matters.

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