

# 2014 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

The **2014 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.

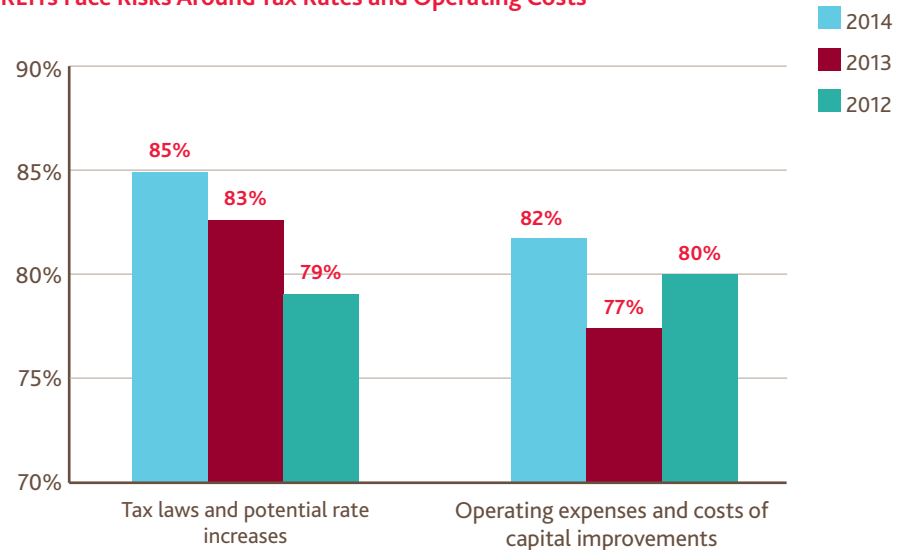
**A**s the real estate industry picks up momentum, industry professionals largely agree that REITs continue to be strong investments. Yet, REITs' performance can vary greatly by sector. For example, healthcare REITs may be poised for year-over-year sustainability due to a number of factors, including the increasing age of the overall U.S. population, while retail REITs continue to face increased challenges due to the widespread adoption of e-commerce and overall customer shopping preferences. Despite these differences, however, REITs across all sectors continue to be exposed to many of the same risks. Many REITs report risks revolving around competition, operating expenses and tenant concerns. Risks related to insurance, illiquidity, interest rates and cyber security are also cited more frequently.

“As the economy continues to improve, more commercial tenants have the monetary flexibility to be selective when it comes to signing a lease. On the other hand, competition within the multifamily sector is increasing due to more tenants looking to rent as a result of the employment uncertainty, challenges in obtaining mortgage financing and generational preferences,” said **Stuart Eisenberg, partner and Real Estate practice leader at BDO USA, LLP.**

### ► INTENSE COMPETITION MAY LEAD TO CAPITAL IMPROVEMENTS

The majority of REITs (94 percent) continue to cite strong competition for lessees and prime real estate as a top risk, ranking it third for a second consecutive year. This may be largely due to consolidation across the industry, low supplies of attractive lessees and cautious investing. While demand for desirable locations and properties remains relatively healthy, those at the lower end of the spectrum are facing growing challenges. As a result, the industry may see increasing numbers of renovations and capital improvements, as property managers and owners work to keep their properties attractive to current and prospective tenants.

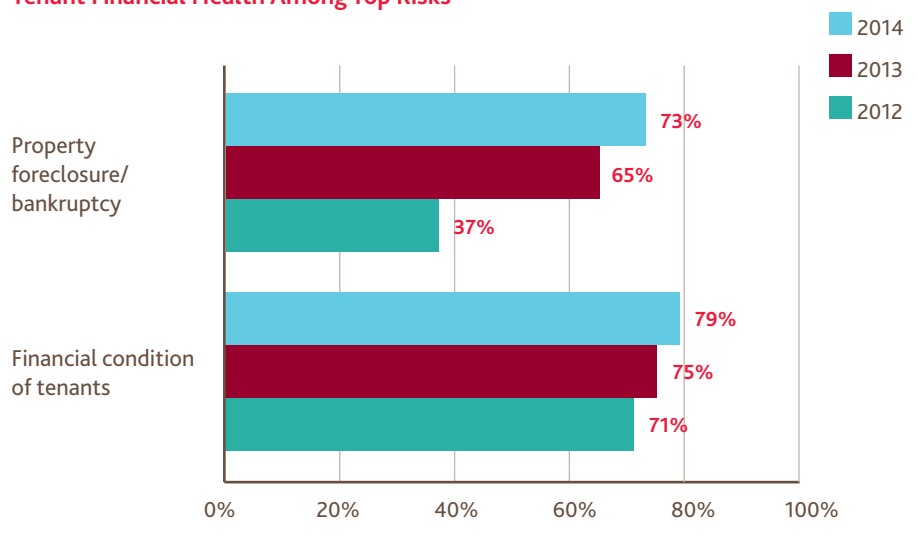
REITs Face Risks Around Tax Rates and Operating Costs



### ► RISING REAL ESTATE TAXES AND UTILITIES COSTS DRIVE CONCERN OVER OPERATING EXPENSES

Changes in property tax rates have a direct impact on REITs' operating expenses. Since tax rates do not move in tandem with REITs' revenue, if tax rates increase while operating cash flow declines, then REITs' operating budgets may be negatively impacted. This may be why 85 percent of REITs cite tax law changes and potential rate increases as a risk, up from 83 percent in 2013. Amid an uncertain tax environment, many REITs have agreements with their property managers to make capital expenditures to renovate and upkeep properties. This may be fueling more concern over operating expenses and costs of improvements, which jumped 5 percentage points from last year, from 77 percent to 82 percent.

Tenant Financial Health Among Top Risks



“The frequency and severity of fires, earthquakes and hurricanes is above the historical norm. Therefore, it is not surprising that many in the REIT community are concerned about the impact of weather on their assets. The expiration of TRIA is causing quite a bit of anxiety in the REIT industry. This stop gap insurance is extremely important especially to the REIT community to make sure that the appropriate risk transfer products are available at a reasonable price point and with appropriate limits to serve the industry,” says **Clark Schweers, principal at BDO Consulting.**

## ► TENANTS' FINANCIAL CONDITION POSES RISK TO REITS

Concern over the financial condition of tenants has been steadily rising, with 79 percent of REITs citing it as a risk, up from 75 percent in 2013 and 71 percent the year prior. The increase in REITs citing this risk is likely related to the difficulty of attracting financially sound tenants. Closely linked to this fear is the risk of property foreclosures, which remain relatively high in certain states like New York, Illinois and Oregon, according to MarketWatch. Seventy-three percent of REITs list property foreclosure and bankruptcy as a threat, up from 65 percent last year.

## ► INSURANCE RISK MAY CAUSE UNDERWRITING CHALLENGES

Passed in 2002, the Terrorism Risk Insurance Act (TRIA) was issued to provide federal support for losses due to terrorism and requires commercial insurers to offer affordable terrorism insurance. Yet, the Act is scheduled to expire at the end of the year, which may be a key factor contributing to the 87 percent of REITs citing inadequate insurance and uninsured liabilities as a risk this year. If TRIA is not renewed, lenders will require proof that such insurance is still in place, which could create short-term underwriting obstacles for many REITs. Concern over natural disasters, war and terrorism, perennial contributors to REITs' insurance concerns, also remain top of mind, with 85 percent of REITs noting it as a risk this year.

### The Top 25 Risks for REITs

2014 Rank	Risk Factor Cited in 10-K Filing	2014	2013	2012
1.	General economic conditions	100%	100%	100%
1t.	Failure to qualify as REIT; Ability to make distributions	100%	100%	100%
3.	Strong competition for lessees and prime real estate	94%	96%	93%
4.	Inability to acquire capital or financing	93%	94%	97%
5.	Increases in interest rates; Hedging risks	90%	88%	92%
6.	Environmental liability	89%	90%	91%
6t.	Inability to sell properties quickly	89%	82%	89%
8.	Inadequate insurance and potential losses due to uninsured liabilities	87%	87%	86%
9.	Federal, state or local regulations	86%	85%	94%
9t.	Anti-takeover and change of control provisions	86%	80%	84%
11.	Tax laws and potential rates increases	85%	83%	79%
11t.	Mergers and acquisitions, joint ventures and partnerships	85%	82%	90%
11t.	Natural disasters, war, conflicts and terrorist attacks	85%	90%	83%
11t.	Payments of common and preferred stock	85%	68%	68%
15.	Debt or financial covenant restrictions	83%	76%	79%
16.	Operating expenses and costs of capital improvements	82%	77%	80%
17.	Financial condition of tenants	79%	75%	71%
18.	Ability to attract and retain key personnel	76%	67%	68%
19.	Indebtedness	75%	85%	90%
20.	Declines or stagnation in business and real estate values; Asset impairment	74%	70%	65%
21.	Property foreclosure; Bankruptcy	73%	65%	37%
22.	Development and construction risks	69%	70%	72%
23.	Security breaches	63%	39%	25%
24.	Volatility or seasonality/cyclicality of results	57%	50%	57%
25.	Credit risk	55%	38%	53%

\*t – indicates a tie in the risk factor ranking

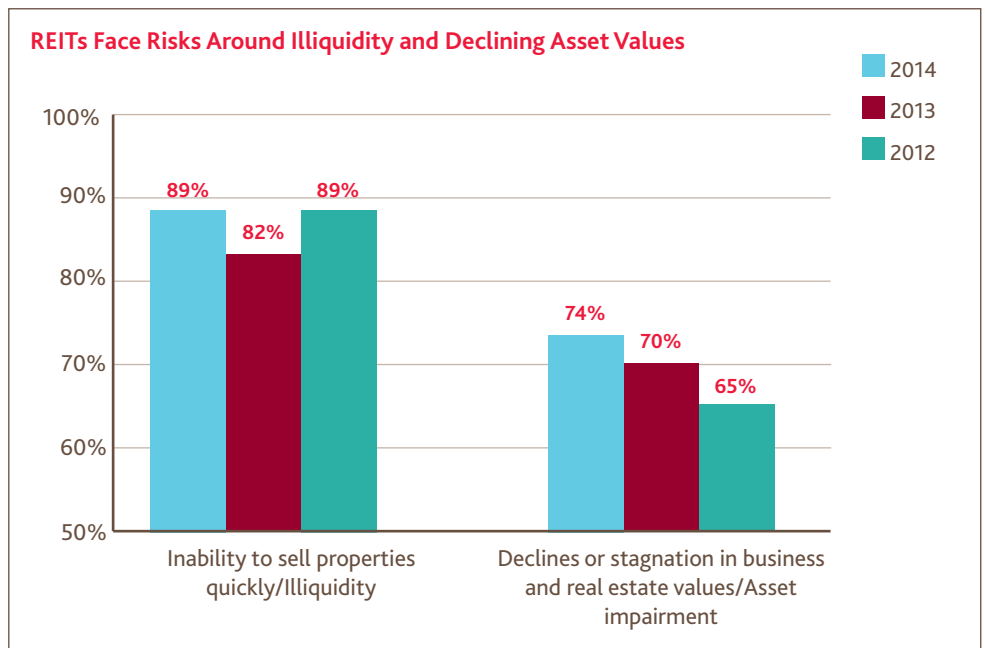
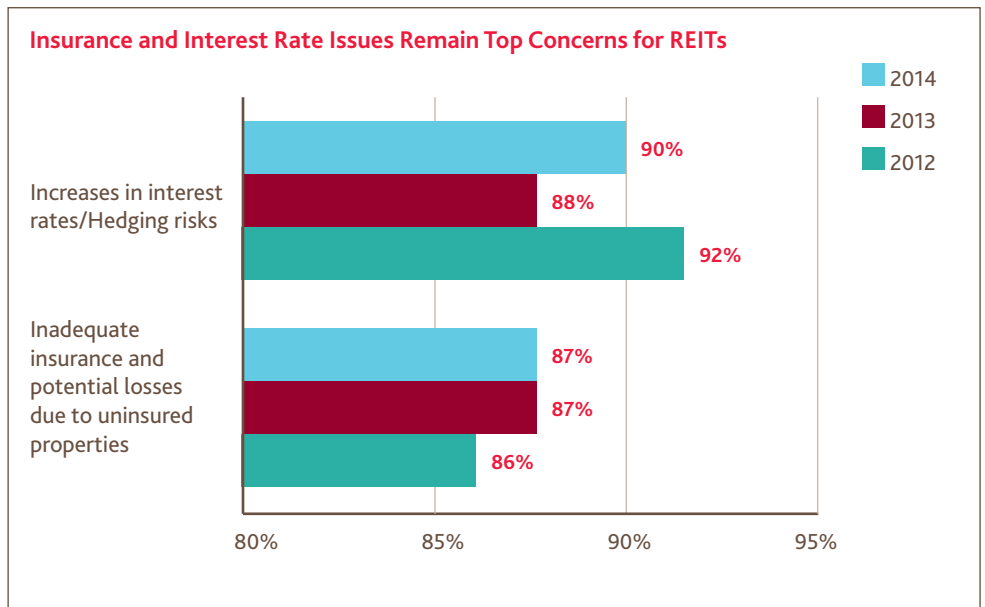
“The illiquidity of real estate assets poses a challenge for REITs with properties in both prime and non-prime markets. While properties in prime markets are priced high to match demand, there is a point over which they become too costly to sell quickly. Those in less desirable markets, on the other hand, see relatively lower demand and have trouble generating interest,” said **John Rainis**, assurance partner in the Real Estate practice at BDO USA, LLP.

### ► WORRIES OVER INTEREST RATES REMAIN

The real estate industry continues to regard interest rates as a top risk, especially as it adapts to the Federal Reserve’s scaling back on its quantitative easy practices. This movement could result in a dramatic surge in interest rates, which could negatively affect REIT returns, raise borrowing costs for property owners and make other investments with higher yields more preferable. Thus far, however, the Federal Reserve has taken calculated steps to allow interest rates to rise gradually, giving REITs the time to guard themselves from potential negative impacts by making any necessary adjustments to their rents net operating incomes. Yet, REITs still fear uncertainty revolving around interest rates, and 90 percent cite upward shifts as a risk, up from 88 percent in 2013.

### ► WHILE THE REAL ESTATE INDUSTRY IMPROVES, CONCERN OVER STAGNATION AND ILLIQUIDITY LOOMS

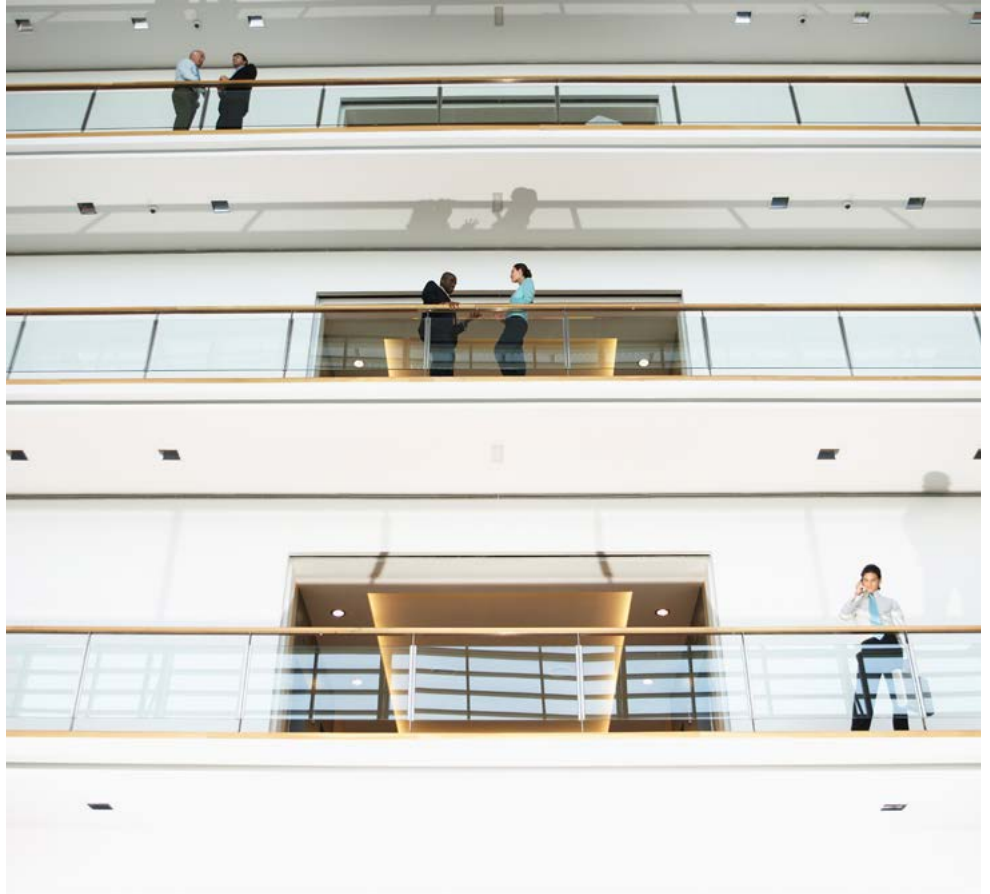
Despite the general consensus that the real estate industry has turned a corner, it appears that scars from the recession have not completely healed. In fact, a growing number of REITs cite declines or stagnation in business and real estate values, as well as asset impairment, as a risk (74 percent note it as a risk, up from 70 percent in 2013 and 65 percent the year before). The emerging real estate landscape is shaping a new pricing environment that REITs may still be adjusting to. Prices are on the rise in prime markets like New York and San Francisco, but if they rise too quickly, properties may not be able to be offloaded quickly enough. On the other hand, while prices in secondary and tertiary markets are relatively lower than their prime market counterparts, debt financing in these markets is scarce. This may be why 89 percent of REITs, up from 82 percent last year, note illiquidity and an inability to sell properties quickly as a top risk.



## ► CYBER SECURITY JUMPS IN THE RANKINGS

Some of the top breaches to make headlines last year included incidents targeting Adobe, Target and Living Social. Today, all industries face the growing risk of cyber security threats, from malware, to strategic, planned cyber crimes. REITs are not immune to this growing business concern. Cyber security risk jumped to 63 percent this year, up from 39 percent in 2013 and 25 percent the year prior. While this risk may be a larger issue for other industries, such as retail, which has enormous amounts of consumer data, and technology, which has highly sensitive information, it is clear that REITs are paying close attention.

*The RiskFactor Report for REITs* reveals that while the overall real estate industry is improving, the evolving landscape is posing new risks to REITs. Industry consolidation may be leading to increased competition and concern over tenants' financial health. REITs are also more frequently citing operating and renovation costs, cyber security and asset impairment as threats. Finally, the continuous concern around increasing interest rates and insurance risks remains top of mind for REITs.



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