2017 U.S. commercial real estate outlook

The impact of U.S. tax reform

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Beneath swirling uncertainties, bedrock made of solid fundamentals, capital flows

Despite strengthening market headwinds and troubling political uncertainties, the U.S. commercial real estate market is likely to remain the top destination for global real estate capital in 2017, and may even see a return to growth, according to a group of leading attorneys, investors, and operators.

Those experts agree that investors surveying the global real estate landscape will largely conclude that the U.S. continues to offer the strongest combination of principal protection and appreciation potential in the near future. No other market in the world offers a more appealing profile on key investment factors:

– Relative political and economic stability

– Strong market fundamentals

– Access to capital

– The potential for advantageous regulatory and tax reform

We chart here the impact of potential U.S. tax reforms on investment into U.S. real estate. In particular, we report on the role tax reform could play in shaping real estate financing structures and encouraging inflows of capital into U.S. real estate.

And while U.S. CRE prices have recently reached historically high levels, further growth could be fueled by the trillions of under-invested dollars held by institutional investors around the world. A significant portion of that capital is either likely or specifically allocated to end up in U.S. commercial properties.

"Compared to other destinations for global real estate capital, the U.S. continues to be very attractive," says Mark Eagan, head of Hogan Lovells' real estate practice. "And the factors driving that are unlikely to change."

And even as the U.S. experiences extraordinary political turmoil, international investors see a broader context. "Today we're all super-concerned with global politics," says William R. C. Tresham, president of Montreal-based Ivanhoé Cambridge, a CDN$55 bn institutional real estate investor. "Business people ranking the places they want to invest still come back to the United States as the number one destination."

Still, investors and developers will encounter a number of unsettled questions in 2017, especially in the areas of taxation and regulation. In hopes of providing a guide to this nebulous terrain, below we have summarized and analyzed the key trends driving the industry and the potential impact of U.S. tax reform.

Policy and tax reform

The election of President Donald J. Trump has drawn mixed reviews from real estate investors. On the one hand, Trump's outspokenness and inexperience have led many observers to preach an abundance of caution, and more than a little skepticism. Executives and investors alike are watching vigilantly for statements or actions that could impact international commerce and capital flows. On the other hand, it's hard to ignore the potential upside that could derive from having a property developer in the Oval Office. The President has espoused an aggressive tax and regulatory reform agenda that could boost domestic growth and the real estate market. Absent specifics, executives agree that the broad drive toward tax reform and reduced regulation would be positive for markets.

But in the administration's first months, investors are already growing anxious for concrete signs of what lies ahead. "The market is long hope and short details," says Sonny Kalsi, founder and partner at New York-based GreenOak Real Estate. "It's really unclear what's going on from a U.S. perspective on policy and economics."

In Congress, tax reform enjoys particularly strong support from Republicans and many Democrats. Lawmakers widely recognize that the tax code is overly complex and many view it as a drag on the competitiveness of U.S. corporations. Such broad consensus, however, is not unusual at the early stages of a major legislative initiative. "The disagreement typically emerges as soon as things start to get specific," says Hogan Lovells partner Jamie Wickett, a leading adviser on tax, energy, technology, and other compliance matters. Still, Wickett believes that in the current climate, tax reform has a high likelihood of passage. While some reform proposals will surely face resistance given the 60-vote legislative hurdle in the Senate, House Speaker Paul Ryan has indicated that Congress might advance tax reform using the budget-reconciliation process, which requires only a 51-vote Senate majority.

The "Better Way for Tax Reform Blueprint," released last year by Ryan and Rep. Kevin Brady (R-CA), provides the clearest road map for GOP-led tax reform. Wickett says House Ways and Means Committee staff began drafting legislative language based on the Ryan-Brady Blueprint in January. "That will be the opening bid on tax reform," he says. A Senate proposal is expected later in the year.

Trump's views on tax reform are less clear. He released a tax proposal before the election, but it reads more like a campaign document than a policy framework. During his February address to Congress, he announced his intention to issue a reform plan (presumably in outline form) soon.

Although tax reform ranks behind health care reform and immigration on the GOP's agenda, Hogan Lovells believes Congress could take up tax reform in late 2017 or early 2018.

While the outcome of that effort won't be known for many months, commercial real estate executives and investors are best advised to engage immediately in the already-active debate on Capitol Hill. We believe reform could be broadly advantageous to the industry, but the current blueprint includes some provisions with the potential to impose fundamental structural change on the industry. And some provisions — such as the possible rollback of interest deductions — could impact both the tax burden on foreign investors and optimal deal structures. "Anyone with exposure or investment in the U.S. needs to understand how

significant the proposed changes could be," says Cam Cosby, a Hogan Lovells partner who advises on tax aspects of real estate transactions.

Below is a discussion of the proposed reforms.

Full expensing

Both the Ryan-Brady Blueprint and Trump's plan would replace the current multiyear depreciation deduction regime with so-called "full expensing" — allowing investors to write off a building's full cost the year it is purchased. The deduction would apply not just to buildings, but also to associated capital expenses, with the apparent exception of land. Any net losses generated by building purchases or other capital expenses could be charged against profits indefinitely, until the initial cost is exhausted, or fully expensed. And net operating losses could offset 90 percent of net taxable income under the proposal.

This change would allow investors to recognize costs far faster than under the current code. Moreover, it would provide a strong incentive to purchase real estate. "A profitable corporation could wipe out almost its entire tax burden by buying a single building," Wickett says.

Interest deduction

In what could be a monumental shift for foreign investors in U.S. commercial property, the Ryan-Brady Blueprint proposes limiting interest-expense deductions. Property owners, under the proposal, would be allowed to deduct interest only when it did not exceed "net interest income," a term that has not yet been defined with precision, but which is believed to mean the difference between interest income and interest expense. If enacted, the proposal could significantly alter the optimal structure for foreign investments. It could have existential ramifications for a leveraged business model that is common in commercial real estate — and present a daunting challenge to those portfolios already operating under such a model.

It is not clear, however, whether Trump will support eliminating the interest deduction. Published reports have speculated that as a real estate executive, he would advocate preserving it — particularly given his historical predilection for using leverage.

Corporate tax cut

With U.S. corporate tax rates among the highest in the world, there is widespread belief in Washington that the tax code stifles growth, hurts U.S. competitiveness and drives both businesses and jobs abroad. So it's no surprise that both the Ryan-Brady Blueprint and the Trump proposal call for sharp corporate tax cuts. The blueprint would reduce the tax rate from 35 percent to 20 percent, and Trump called for it to be set at 15 percent. Should either proposal become reality, the commercial real estate sector would reap obvious benefits — though, as noted in the following section, the reduction in rates come with associated structural changes that could make real estate investment trusts (REITs) less attractive.

For starters lawmakers will need to find ways to pay for the proposed rate cuts. The blueprint calls for a "Border Adjustment Tax" (BAT) to offset corporate-tax revenue losses. But such a measure faces daunting political obstacles on the road to passage (for more information, see below). If the BAT fails, lawmakers would either need to retreat to a more modest corporate tax cut, or accept a larger deficit. The latter, which many observers view as more likely, would probably provoke growth, inflation, and higher interest rates.

Corporate tax cut impact on REITs

Taken together, the blueprint's proposed changes to corporate and dividend taxation could make REITs far less attractive — if those changes are enacted as currently described. In addition to a significant corporate tax cut, the blueprint envisions lower rates on individual dividend income, effectively reducing the highest investment income tax rate to 16.5 percent. For top tax bracket earners, for example, corporate real estate earnings would be taxed at 33.2 percent (20 percent corporate tax plus 16.5 percent tax on the remaining dividends), whereas REIT income would be taxed at the highest (proposed) income tax bracket, or 33 percent. Given other constraints faced by REITs, their appeal as pass-through entities could be diminished compared to C-corporations.

"This would be a gating issue for real estate investing," says Hogan Lovells partner David Bonser, who heads Hogan Lovells' Equity and U.S. Debt Capital Markets Practice group. "It could change the whole discussion around the best structure for holding real estate."

Border adjustment tax

Among the Ryan-Brady Blueprint's most controversial ideas, the BAT is intended to encourage U.S. companies to export and to produce domestically. While details have not been released, Hogan Lovells understands that the proposal would exempt all export sales from taxation, while eliminating the deduction for import costs.

The BAT is an integral part of the Ryan-Brady reform, but it already faces uncertain, at best, prospects in the Senate and a battery of formidable opposition, including from retail and oil interests. However, in his February address to Congress, Trump echoed the rationale underpinning the BAT, without specifically endorsing the plan. Hogan Lovells expects him to propose, at minimum, a structure that would impose taxes on at least some imported goods.

Passage of the BAT would represent a profound change to the U.S. tax code, with impacts rippling throughout the economy, including in real estate. For example, by wiping out the advantages of locating operations and assets abroad, demand for domestic office and industrial properties could increase. Further, economists predict that it could increase the value of the dollar by as much as 25 percent, which would represent a daunting price increase on U.S. properties for foreign investors. (For more information on the BAT, see our recent update here).

Like-kind exchanges

Like-kind exchanges, which enable investors to defer capital gains taxes by exchanging a property they own for a similar property, have not been specifically addressed in the existing tax documents. Given the oft-stated goal of simplifying the tax code, some believe this mechanism could be limited or even eliminated.

Repatriation of foreign profits

Congressional leadership in both parties has expressed a general desire to lure back the more than US$2tn in earnings that American companies currently hold overseas. During the presidential campaign, Trump proposed a one-time, 10 percent tax on repatriated foreign earnings. The Ryan-Brady Blueprint states that “American companies will be free to bring their foreign earnings home to invest in America without tax penalty.” If enacted, this could result in significant benefits to U.S. real estate firms with properties abroad. It could also relocate a huge amount of idle capital back to the U.S., stimulating additional investment.

Potential changes to FIRPTA

In late 2015, Congress passed the PATH Act, amending the Foreign Investment in Real Estate Property Act (FIRPTA) to free certain foreign pension funds from paying capital gains tax on the sale of U.S. real estate, bringing their tax treatment in line with their domestic counterparts. Intended to spur U.S. investment by cash-rich foreign pensions, the changes had little effect in 2016, as investors awaited regulatory guidance from the IRS and asked Congress to iron out technical details. As a result, foreign pension funds still lack confidence that they are on a level playing field, leaving a potentially significant capital source on the sidelines. “Those investors make decisions based on after-tax returns, which will be very difficult to project until we get clarity on FIRPTA,” says Hogan Lovells’ Cosby.

So far, neither the Trump plan nor the Ryan-Brady Blueprint has specifically addressed FIRPTA. However, both the President and congressional Republicans

envision significant changes to international taxation, opening the possibility for revisiting FIRPTA. Given the President's preference for "America first" policies, it is not clear that he would make FIRPTA reform a priority, nor whether he would back changes advantageous to foreign investors. Hogan Lovells will be monitoring the negotiations closely.

Interest rates

Aside from policy changes, interest rates represent the most pressing matter on the minds of commercial real estate executives and investors. With Federal Reserve guidelines suggesting two additional rate hikes following the quarter-point increase in March, industry leaders expect the cost of capital in real estate to climb as well — despite wishful speculation by some analysts that the two might decouple.

What matters most, executives say, is the pace and scope of tightening. "The real question is whether businesses keep expanding and taking on space at a pace that keeps demand in line with rate increases," says Warren Gorrell, CEO Emeritus and partner of Hogan Lovells, who specializes in complex M&A transactions and IPOs for REITs. If business expansion slows, higher rates could inhibit property prices as well as REIT share values, Gorrell says. For the moment, investors are updating their models to account for expected higher capital costs.

But Gorrell, a 30-year veteran of commercial real estate industry, notes that even with a series of increases, the current cycle offers historically low interest rates. That, combined with solid fundamentals and the expectation that rates will climb slowly, with ample warning from the Fed, leads him to believe that capital costs do not appear poised to stifle transactions in 2017.

Real estate veterans further point out that rising rates can yield opportunities, triggering sales by firms that are over-leveraged or spooked by near-term price fluctuations. Some even see higher rates as good news. "I'm of the view that interest rates rise because the world is getting better," says Ivanhoé Cambridge's Tresham. "If the world is better, companies are taking more space, hiring more people, taking more risk, borrowing more money" — all of which boosts long-term real estate returns. "With the global financial crisis hangover still lingering," he continues, "a healthy slice of North American corporate leaders are still not aggressively managing for growth, so business confidence has room to grow."

Real estate fundamentals

Nearly a decade into the expansion that began in the depths of the global financial crisis, real estate executives are watching for signs that the business cycle is coming to a close. At more than 90 months, the current upturn is one of the longest in U.S. history. And while it far outstrips the 58-month cycles typical of the post-World War II era, the trend in recent decades has been toward longer expansionary periods. This one — characterized by slow growth, disciplined lending, and below-average development — appears to be extraordinary in its long-haul profile.

While there still appear to be attractive opportunities in select asset classes, there have undoubtedly been rough patches in recent quarters as well. Kalsi, of GreenOak Real Estate, contends that investors have been in "wait-and-see mode" since the June 2016 Brexit vote helped exacerbate the usual summer doldrums, which stretched into fall, when investors decided to await the outcome of the U.S. election. "We saw a big slowdown in capital flows post-

Brexit," Kalsi says. "And the continued uncertainty is keeping U.S. investors cautious." Nevertheless, Kalsi concludes that he's not "super-bearish. We are still looking for opportunities."

Data on large commercial real estate transactions support Kalsi's assessment of last year's activity. Year-over-year large-cap sales volume declined by 20 percent overall in 2016; apartments were the only large property type that posted a sales increase, at a modest 3 percent, according to data collected by Real Capital Analytics (RCA). Despite the sales decline, RCA reported that large-cap prices in the asset class were up by 9 percent, closing 24 percent above the prior 2007 peak. Meanwhile, the sector reported solid demand, rising construction and declining vacancy rates for most classes (other than multifamily). As for small-cap sales, notwithstanding concerns over tight inventory, both sales and prices were up, with volume increasing by more than 8 percent in every quarter last year. International sales accounted for 11 percent of small-cap volume.

Tresham, who is "very bullish about the fundamentals," says he and his colleagues at Ivanhoé Cambridge are finding good opportunities to purchase U.S. properties at attractive prices, below replacement value, in select asset classes and locales. Due to the demographic trend toward urban living, he sees inner-city properties in major cities like Los Angeles and Chicago as a good target. He also says that new developments are in demand, as companies seek updated architecture to accommodate technology and evolving work environments. Despite the maturity of the current business cycle, he argues that economic conditions — particularly underemployment, pent up investment capital, and a pro-growth regulatory environment — support continued strength in the real estate market.

Investors remain cautious on retail, given the competition from digital commerce, and on "trophy" properties, which currently command premium purchase prices that might prove unjustified. Likewise, while some investors view New York City as an attractive long-term core investment, the market appears to be experiencing some over-building, particularly in condos and hotels, and is laboring to wean itself off of the financial services industry.

In general, however, the outlook for 2017 is positive, with economists projecting moderately accelerated growth at 2.4 percent, payroll expansion at 1.4 percent, a decline in unemployment to 4.6 percent, and modestly stronger inflation.

Capital flows

The 2017 commercial real estate market appears poised to get a boost from the powerful, unprecedented influx of foreign capital. The trend is historic, and secular, driven by massive quantities of capital seeking secure but productive investment opportunities. Given the prospect of current return along with the chance of appreciation, institutional investors are increasingly looking to real estate as a necessary asset class. Many institutions around the world holding billions or even trillions of dollars in assets remain under-allocated in real estate.

The abundance of overseas capital pouring into commercial real estate clearly helps explain the persistence of the current growth cycle. "Foreign capital changes the game," says Hogan Lovells' Gorrells.

If there is a cloud on the foreign-capital horizon, however, it is drifting in from the East, with investors and executives expecting Chinese investors to be less active in the U.S. this year. Many Chinese firms are finding it increasingly difficult to invest abroad, constrained by uncertainties surrounding the Chinese economy, and by Beijing's strict capital controls — prompted by a rapid decline in foreign reserves. Moreover, some speculate that the Trump administration's hostile rhetoric toward China could be causing investors there to put U.S. investments on the back burner, at least for the moment.

But diminished Chinese activity is likely to be mitigated, if not negated, by stronger flows from elsewhere in Asia, particularly from Japan, South Korea, and other countries with huge under-invested institutional assets. Investors point out that Asian insurance companies, pension funds, and sovereign wealth funds tend to significantly trail North America in allocating to real estate. For example, Japan is awash with cash-rich investors carrying relatively small real estate allocations — Japan Post Holdings (with some US$2.5tn in assets), Government Pension Investment Fund, (US$1.2tn), and Pension Fund Association (US$100bn). Confronted with Japan's negative interest rates, weakening Yen, and aging, shrinking population, those investors are certain to diversify abroad.

Despite uncertainties surrounding the election of an unconventional president, industry leaders say the U.S. still offers many comparative advantages for overseas investors. However uneasy the political climate may be, no other nation can boast an equal combination of strong sovereign currency, pro-business regulatory environment and reliable legal system — not to mention an economy that appears vibrant and resilient compared to global peers. Following Brexit and the U.S. election, investors are particularly anxious about the elections in France, Germany, and the Netherlands this year, where anti-EU parties are polling strong. Further, political volatility in Italy and mounting pressure on the country's banks are also pushing capital toward the U.S.

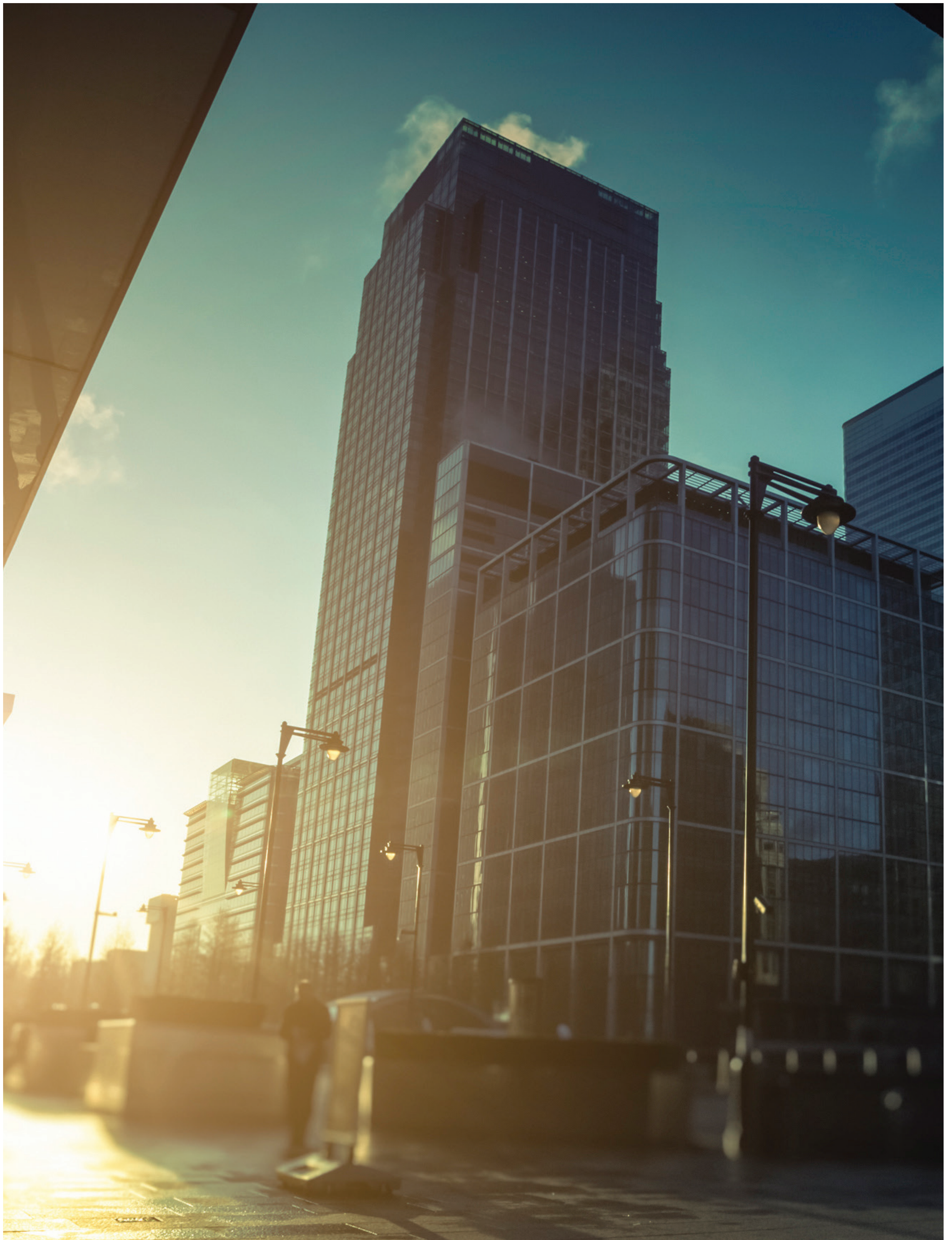
"If you're a foreign fund manager investing your client's money, you're not going to get fired for investing in the United States," says Hogan Lovells' Bonser.

Conclusion

Nearly a decade has passed since the trough of the global financial crisis, which is fueling debate among real estate executives regarding the length of the business cycle. And the U.S. is clearly embarking on a cycle of monetary tightening. But with ample labor slack, idle capital, and the prospect for regulatory relief from Washington, leading real estate minds believe there is plenty of room for additional growth.

The impact of U.S. tax reform on U.S. real estate investment could be dramatic. Whilst restrictions on interest deductibility could negatively impact the after-tax returns of real estate investors, the real estate industry would be likely to receive a significant boost from moves towards full expensing of the acquisition costs of U.S. real estate, further clarification on FIRPTA and any incentives to repatriate foreign profits.

For 2017 in particular, there are many reasons to be optimistic, particularly for investors who are careful about leverage, target markets, and asset class selection.



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