

COMMERCIAL REAL ESTATE ROUNDTABLE



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Presented by

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COMMERCIAL REAL ESTATE ROUNDTABLE PARTICIPANTS

Haskell & White LLP

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Stuart Kane LLP

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– Paul Louis, CPA
Audit Principal
Haskell & White LLP

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► What trends are you seeing in the commercial real estate industry? How are they affecting the legal industry?

Bruce Stuart, Stuart Kane LLP:

Currently, we are seeing a significant amount of transactional activity in commercial real estate. This includes refinancings to take advantage of the current interest rate environment and disposition and acquisition of income producing properties as clients look to refine their portfolios. As such, this is creating demand for experienced real estate lawyers to handle these transactions. However, there is a general sense of caution given the long timeframe that has elapsed since the recession began in 2007-2008.

► What current industry regulations are having the greatest impact on your clients?

Paul Louis, Haskell & White LLP: Drastic new changes in lease accounting are affecting clients in all industries. The new standard for lease accounting has been in the works for many years, and in February 2016, the Financial Accounting Standards Board (FASB) issued the final standard. The new lease accounting rules eliminate the off-balance sheet treatment for operating leases, which were mostly used

under the old rules. With certain exceptions, the new standard will require lessees to recognize the assets and liabilities associated with their leases on the balance sheet. That is, operating lease commitments will now be prominently displayed on the balance sheet as liabilities, rather than presented in a simple footnote. As a result, companies should reconsider their lease-versus-buy decisions and strategies. Landlords can expect tenants to seek early renegotiation of their existing lease agreements, such as requesting shorter lease durations with more renewal options. For certain types of real estate properties, the new accounting standard will likely have a direct and/or an indirect impact on real estate values. In addition, landlords should seek to fully understand the financial statement impact of the new lease accounting rules so they can effectively evaluate a prospective tenant's financial position and strength. The new lease standard is effective for fiscal years beginning after December 15, 2018 for public companies, and December 15, 2019 for private companies – early adoption is permitted.

► Is the trend toward urbanization changing the face of Orange County real estate?

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Depending upon how the election shakes out, there could be significant impacts to the extent of changes in the tax code to reflect higher or lower tax rates, higher tariffs that would affect international trade and the demand for distribution centers.

– Bruce Stuart
Co-Founding Partner
Stuart Kane LLP

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– Rick Smetanka, CPA
Audit Partner-in-Charge
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Bruce Stuart, Stuart Kane LLP: There is definitely a trend in the Orange County airport area towards higher density mixed-use projects. It will be interesting to see if this creates a true urban core with the necessary services for those residents and what impact that has on the infrastructure.

► **What are the trends on interest rates and availability of capital in the industry? What are your thoughts on today's capital markets in terms of opportunities and challenges?**

Tim Titchenal, Haskell & White LLP: From an immediate perspective, the Federal Reserve Board's second quarter survey indicates a modest amount of tightening in lending standards on stronger demand, challenging investors to find the right banker for the type and size of the debt desired to get the best available terms. Additionally, new regulatory requirements, including the new risk retention rules, are causing concern as they are only beginning to be priced into the market and will likely drive the lending environment to be more restrictive. From a broader perspective, short-term bridge financing and permanent financing rates remain attractive. However, the combination of that rate environment and available capital's focus on fixed income is causing demand to outstrip opportunities. Yet, rents have risen only modestly. As a result, pricing is being pushed to peak levels, and it has become difficult to deploy capital without adjusting return expectations. Opportunities may begin to present themselves in the form of coming commercial mortgage backed securities, debt maturities, and debt and equity fund wind-downs as properties are forced to be recapitalized. While the combination could lead to the perfect storm to devalue the market, it also could also be a Y2K non-event.

► **How will the outcome of the upcoming election impact the commercial real estate industry overall?**

Bruce Stuart, Stuart Kane LLP: The uncertainty due to the current election environment and the possibility of a change in party in the presidency, and/or in the control of the Senate in the short term, may create a wait-and-see attitude. Depending upon how the election shakes out, there could be significant impacts to the extent of changes in the tax code to reflect higher or lower tax rates, higher tariffs that would affect international trade and the demand for distribution centers, amongst other possibilities.

► **What are the potential challenges and pitfalls expected over the next 12 months?**

Rick Smetanka, Haskell & White LLP: While the U.S. economy isn't likely to break any performance records in the near-term, declining overall unemployment, generally well-performing investment markets and global geopolitical instability have created, relatively speaking, the most inviting economic environment in the world. However, like a snake in the grass, potential challenges and pitfalls are plenty. It is well-documented that investment markets despise uncertainty, and unfortunately, the near-term menu features a steady diet of uncertainty for investors, developers and business owners. To say the least, it will be challenging to discern how the commercial real estate market will react to the upcoming presidential elections and the anticipated increases in the Federal Reserve Board's benchmark interest rate. After a healthy rebound since the 2008 global financial crisis, many of our clients are questioning the higher market valuations and low cap rates that are prominent today, and they are wondering how much runway remains. Our markets are also facing challenges from a slowing Chinese economy (which is slowing investment capital into American commercial real estate), and our markets are more susceptible to an ever-growing list of geopolitical risks, including Brexit; political instability in the Middle East; and tensions with Russia, North Korea and Iran. Of course, the industry continues to be challenged by the rapid pace of change that tenants (especially millennials) demand in areas such as creative and fun work environments, intelligent buildings and sustainable footprints.

► **How are your clients dealing with the current economic uncertainty?**

Bruce Stuart, Stuart Kane LLP: Our clients are trying to maintain a low level of leverage with properties that are able to withstand most downturns. Most clients are trying to be in a position to react defensively. However, that is not as easy to do with development projects where, given the time it takes to entitle and develop a project, it is difficult to time the market.

► **Over the next five years, what are the most important commercial real estate trends that will impact Orange County?**

Rick Smetanka, Haskell & White LLP: Over the years, there's no doubt that Orange County has experienced its share of real estate booms and busts. The current

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residential real estate market is strong, and in general, the Orange County housing market has more than made up its recessionary losses. In fact, Orange County is now one of the most expensive housing markets in the country, and it suffers from one of the lowest home-ownership percentages in the country. Against this backdrop, I expect workers, entrepreneurs and businesses to continue to leave Orange County (and California), which will negatively impact most real estate asset classes. Also, combining our modest economic growth, which is increasing demand for labor, with economists' predictions of below-average U.S. labor force growth rates, companies should prepare for intense recruiting battles to attract, engage and retain the best talent. As businesses compete for the best workers, the winning commercial real estate developers and managers will be those that are forward-thinking and innovative. Our clients are expecting a higher ROI from their real estate expenditures and they expect those funds to help them achieve a competitive advantage over their peers and competitors, while also providing stimulating and fun work environments that will attract the best and brightest millennials.

► **What is the one piece of advice you would give to well-established commercial real estate investors if the market becomes more and more uncertain?**

Bruce Stuart, Stuart Kane LLP: The lesson learned from prior recessions is the ability to ride out the downturns by maintaining adequate debt service coverage, lower leverage and cash reserves. Ultimately, there will be buying opportunities created by the downturn as part of the normal cycle.

► **What should a prospective buyer or seller of commercial property look for in a broker? What should a client expect from its broker, and what protections does the client have?**

Josh Grushkin, Stuart Kane LLP: Collaboration and follow-through are two aspects we encourage our clients to look for in a broker. We find efficient and successful transactions involve a cohesive team comprised of client, broker and attorney, all working together. When recommending brokers to our clients, we look not only for seasoned experience, but a demonstrated team-oriented track record in seeing deals through to closing. Clients should expect their broker to not only help at the beginning, with target property selection or marketing of the property to be sold, but to also take a quarterback-like approach during the entire deal. Communication is

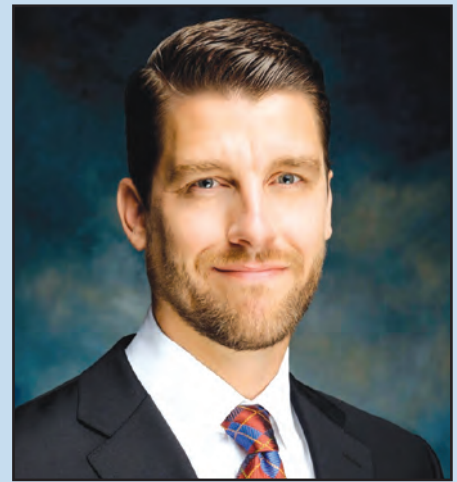
important, not only among our team, but also with the opposing broker, especially while we negotiate legal points with opposing counsel. The best protection for the client's interest, in addition to having legal counsel involved, is to make sure they have a dedicated broker on their side, avoiding dual-agency representation or other potential conflicts of interest in the transaction.

► **What concerns do you see that commercial real estate investors are having as they consider either purchases or changes in their portfolio?**

Tim Titchenal, Haskell & White LLP: Long-term investors are moving forward cautiously in consideration of the low cap rate environment. They are primarily looking for quality assets in the C+ to AAA range with value-add opportunities being relatively limited. For those deploying capital, a significant challenge in the acquisition process has been trying to determine why the seller is selling. Issues such as maturing tenants are being discovered on due diligence leading to increased workload and dead deal costs. Investors are also becoming more cognizant of geographical exposure and are willing to give on price consideration in return for the right diversification. With respect to those repositioning their portfolio, investors are looking to monetize value creation, eliminate lower-rung assets and transition out of underperforming sectors.

► **With transactions increasing, both in volume and the speed in which deals are done, what are the best ways to document commercial real estate transactions? Are industry-approved forms adequate?**

Josh Grushkin, Stuart Kane LLP: For most transactions, we encourage our clients to use custom-prepared agreements and leases, rather than industry form documents. This is both for flexibility in being able to draft deal-specific provisions, as well as efficiency in doing so. While we can, and do, accommodate the use of AIR forms for relatively simple transactions, or perhaps when one party insists upon it, the cumbersome nature of the AIR software can actually make the turn-around time using those forms slower compared to our custom-drafted documents using Word. Plus, the standard AIR forms lack certain provisions our clients expect to be addressed in their deals, including certain representations and warranties, remedies for defaults and other unique elements of more complex transactions. Since those needs usually then require us to prepare a custom addendum to complement the AIR form, we typically find it more efficient to simply document the entire transaction using the custom agreement.



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