US Real Estate Insights

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Dear Clients and Friends,

On behalf of PwC's Real Estate Practice, it is our pleasure to offer another edition of US Real Estate Insights. This publication provides perspectives on the latest market and economic trends, regulatory activities and legislative changes affecting the real estate industry, as well as informed views of the most current developments in operations, business strategy, taxation, compliance and financing.

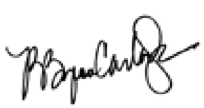
Consistent with our global vision statement – to build trust and work toward solutions to the world's biggest problems – we continue to bring you thought leadership that is relevant to your industry, while also speaking to your topical needs related to accounting and financial trends and updates.

As the recovery cycle continues, the market similarly continues to indicate it may be a good time to invest in real estate. To this end, we are especially pleased to provide insightful articles in two areas of growing popularity within the real estate investing community – single family homes and student housing.
As often observed, growing opportunity requires a growing need for capital. In "Single family rental securitization," Phillip Thigpen discusses how debt securitizations collateralized by single family rental homes are increasing in popularity and providing investors with an innovative new way to leverage their equity capital investments. Additionally, in "National student housing market," Susan Smith discusses how positive demographic trends relating to student population growth is creating a positive investment opportunity in the student housing market, likely leading to additional capital investment in the near future.

We also encourage you to read our flagship thought leadership piece, ***Real Estate 2020: Building the future***. As confidence returns to real estate, the industry faces a number of fundamental shifts that will likely shape its future. To help real estate managers and the investment community better plan, we have looked into the likely changes in the real estate landscape over the coming years and identified the key trends which, we believe, may have profound implications for real estate investment and development.

We hope you will find US Real Estate Insights to be informative and helpful to you in your business.

As always, we encourage you to share your thoughts, opinions and suggestions. For more information or to be added to our distribution list, please feel free to contact the authors of this edition's articles or your local PwC representative.



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Single family rental securitization

by Phillip Thigpen

The single family rental landscape

Single family rental (SFR) securitization is the sale of debt instruments collateralized by single family rental properties. Cash flow streams from leaseholds on the properties are used to make payments to holders of the SFR securities. Five single family rental companies have successfully completed SFR securitizations. The securitizations represent an opportunity for SFR portfolio holders to leverage their investment in single family properties, and thus generate a higher rate of return on equity. To date, all of the transactions sold in the marketplace have been structured as private placements.

According to the websites of three of the Nationally Recognized Statistical Rating Organizations (NRSRO), Kroll Bond Rating Agency, Moody's Investor Service, and Morningstar Credit Ratings, LLC provided ratings for each of the SFR securitizations. Each transaction generated a AAA rating.

SFR securities represent a new type of fixed income security. The inaugural SFR securitization transaction was completed in November 2013.[1] The transaction sponsor was Invitation Homes, the Dallas-based single family rental portfolio holder which owns over 43,000 homes, the largest portfolio of single family homes. According to Bloomberg on November 13, 2013, Deutsche Bank Securities was lead underwriter. Subsequent transactions were sponsored by Colony American Homes and American Homes 4 Rent and lead underwriters were JPMorgan Securities and Goldman, Sachs, respectively. Each of the transactions provided a LIBOR-based floating rate coupon to investors.[2] Recent SFR securitizations were marketed by two publicly-held REITs, Silver Bay Realty and American Residential Properties, Inc., according to NRSRO pre-sale reports.

The single family rental business existed in the United States prior to the financial crisis. Before 2008, according to NAREIT[3], there were

1 Bloomberg, *Blackstone Lures Investors to Home-Rental Bonds: Credit Markets*, November 6, 2013
2 Bloomberg, *Colony Plans to Sell $559 Million of Rental-Housing Bonds, July 14, 2014; Bloomberg, American Homes Said to Seek Lower Spreads on Rental-Bond Deal*, May 12, 2014
3 *Single Family Rentals: Demographic, Structural and Financial Forces Driving the New Business Model,* Calvin Schnure, NAREIT, March 31, 2014

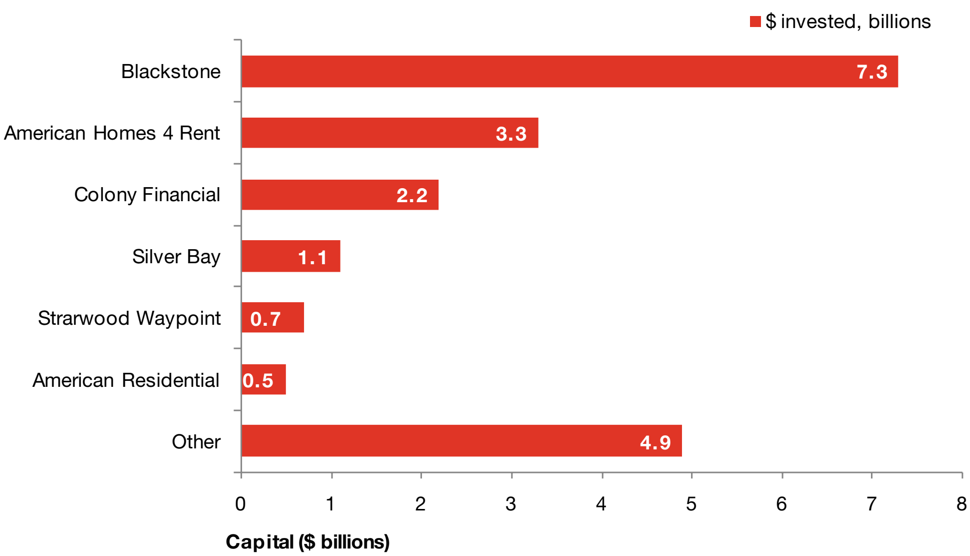
more than 10 million single family rental properties, about 10% of the US housing stock. However, since the onset of the financial crisis, the homeownership rate in the US has declined from a peak of 69% in 2005 to 65% in 2013. As homeownership has declined, rental in both multifamily properties as well as single family properties has increased. Since 2007, single family rentals have increased by nearly 2 million units. NAREIT points out that at an average price of $150,000, $275 billion of capital would be required to fund investment in the 2 million additional single family rental properties. SFR securitization provides a portion of that capital requirement in the form of debt capital.

Since the financial crisis, large scale single family rental property portfolios have been constructed by multiple institutional investors. Some companies, such as Silver Bay Realty Trust Corp., Starwood Waypoint Residential Trust and American Residential Properties are public companies. Others are sponsored by private equity firms and other institutional investors. The companies all have a commonality, which is that their single family property portfolios were funded, in large part, with equity capital. The single family rental securitization industry has arisen because of shareholder's desire to leverage that equity capital investment.

Bulk REO sale by Fannie Mae

In 2012, according to Congressional testimony, Fannie Mae and Freddie Mac held over 180,000 single family homes acquired through foreclosures. The unprecedented size of this portfolio caused their regulator, the Federal Housing Finance Agency, to direct the development of a pilot bulk sale program of REO to accelerate the disposition of this portfolio of single family homes. The pilot sale in 2012 consisted of about 2,500 single family homes. All of the homes in the sale had rental tenants in place at the time of the sale. As part of the sale, conducted by Credit Suisse on behalf of Fannie Mae, institutional investors were offered a synthetic financing alternative which represented the first structured finance transaction in the single family rental market, according to *Fannie Mae Single Family Residential REO Rental Structured Transaction History*. Investor interest in the structured finance alternative indicated strong demand for finance products in the single family rental marketplace.

Largest institutional investors in the single-family rental market



Source: *2014 Outlook: Single Family Rental Securitizations*, Deutsche Bank Markets Research, December 3, 2013, company filings and websites, new reports

SFR transactions done to date

The first single family securitization completed by a private entity was sponsored by Invitation Homes in November of 2013. That transaction was a template for the seven subsequent SFR securitizations that have been executed to-date.

SFR transaction volume and projections

Additional SFR securitizations are expected to come to market in 2014, from both new and existing issuers. Market participants estimated at a recent IMN single family rental conference that the volume of issuance in 2014 will be approximately $5 billion.

Transaction summary

Transaction	CAH 2014-2	CAH 2014-1	IH 2014-SFR1	IH 2013-SFR1	AH4R 2014-SFR1
Loan Balance ($ mm)	$558.50	$558.50	$993.74	$479.14	$480.97
Interest Rate (1m LIBOR +)	177bps	177bps	189bps	176bps	163bps
Initial Loan Term	2 years	2 years	2 years	2 years	2 years
Extension Option	Three 1-yr options	Three 1-yr options	Three 1-yr options	Three 1-yr options	Three 1-yr options
Amortization Type	None	None	None	1% per year	1% per year
Issuer DSC at Current LIBOR	2.83x	2.83x	2.85x	2.12x	2.73x
DSC Threshold for LIBOR Cap	1.2x	1.2x	1.2x	1.2x	1.2x
Property Information					
Property Count	3,727	3,399	6,473	3,207	3,852
Purchase Price ($mm)	607	540	954	445	485
Issuer BPO Value ($mm)	798	734	1,325	639	687
Average BPO Value ($)	214,076	215,851	204,694	199,205	178,375
Number of MSAs	22	20	28	19	24
Average Home Age (years)	24	28	26	30	
% Occupied	100%	100%	94.80%	100%	100%
Servicer	Midland	Midland	Midland	Midland	Midland
Special Servicer	Situs	Situs	Situs	Situs	Midland

Transaction	IH 2014 SFR2	SBY 2014-1	ARP 2014 SFR1
Loan Balance ($ mm)	$720.02	$312.7	$342.7
Interest Rate (1m LIBOR +)	187bps	194bps	206bps
Initial Loan Term	2 years	2 years	3 years
Extension Option	Three 1-year	Three 1-year	Two 1-year
Amortization Type	None	None	None
Issuer DSC at Current LIBOR	1.20x	1.20x	1.25x
DSC Threshold for LIBOR Cap			
Property Information			
Property Count	3,750	3,089	2,880
Purchase Price ($mm)	$670	$328.8	$420.2
Issuer BPO Value ($mm)	$912	$481.0	$489.6
Average BPO Value ($)	$243,210	$155,722	$170,007
Number of MSAs	28	12	23
Average Home Age (years)	28	24	12
% Occupied			
Servicer	Midland	Midland	Midland
Special Servicer	Situs	Midland	Situs

Source: *American Residential Properties 2014-SFR1, U.S. Structured Finance Presale Report,* Kroll Bond Rating Agency, August 6, 2014

Transaction structure

All of the SFR securitizations sold to-date have had similar structures. A non-recourse first-lien mortgage loan was originated, secured by fee-simple interest in all of the single family residential properties in each transaction. The depositor purchased the loan from the originator and deposited the loan into a trust. The trust holds the loan, which is funded by the simultaneous sale of certificates by placement agents to investors. Certificates are sold to investors by the placement agents.

The loan is supported by cash flow streams from leases on the properties as well as equity interests in the properties.

The transactions have all been sequential pay structures.

Each transaction designated both a primary servicer as well as a special servicer.

Transactions to-date have been LIBOR-based floating rate deals with a two year term and three 1-year extension options or a three year term with two 1-year extension options. Three of the 8 transactions issued to-date had a 1% amortization feature, and five are interest only structures. Maximum LTV financed thus far is 79% of Broker's Price Opinion, or BPO.

Key challenges

As noted earlier, the first SFR securitization took place in November of 2013. As such, these transactions represent a new fixed income investment vehicle which pose liquidity, relative value, pricing and operational challenges. Because SFR companies are vertically integrated, and contain real estate management and operational capability as well as capital markets functions, investors must assess additional risk parameters when they review SFR securities as a possible investment alternative. These risks include:

Operational risk

Issuers must manage the acquisition, rehabilitation, maintenance of properties. SFR properties must be turned over and prepared for a new lease when a lessee terminates a lease contract. SFR properties must be marketed and leasing inventories must be turned rapidly. Renewal rates must be kept at a high level. Properties, although generally concentrated in localized markets, are not contiguous and require scattered site property management on a large scale. New acquisitions must be prepared for rental. These elements present operational challenges to SFR companies, all of which are relatively new companies.

Compared with the multifamily industry, SFR property management companies have relatively little experience managing large portfolios of SFR properties. In addition, performance metrics are not standardized across industry participants, an element that poses a challenge to analysts who are attempting to compare SFR company financial performance.

Historical data

Because the SFR business has only built large portfolios in the last few years, there is no data available regarding the performance of SFR portfolios through multiple economic cycles. The rating agencies made adjustments for this lack of historical data by stressing cash flows from underlying properties in SFR securitizations to develop default probability and to determine loss given default. Nonetheless, long-term performance metrics are not available for SFR securities.

Future developments in the SFR securitization market

SFR securitizations completed thus far feature property management that is either a part of the corporate structure of the transaction sponsor, or third-party property managers that are tightly controlled by the transaction sponsor. Rating agencies all have affirmed the importance of the role of the property manager in SFR securitizations, and have identified strong property management as a risk mitigant. Future transactions in the SFR market may feature transaction sponsors who employ multiple property management firms. Because of the key role property managers play with regard to rehabilitation, maintenance, turning over properties from lessee to lessee, these transactions will pose a valuations and ratings challenge because of the transaction's modified risk profile. Future SFR transactions may also feature multiple borrowers, which would also present investors with incremental analytical challenges. Finally, some firms in the SFR industry are building capacity to acquire and service non-performing single-family mortgage loans, both for the return on those loans and for the incremental supply of single family real estate that a non-performing mortgage loan servicing platform will supply.

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National student housing market
Growing in popularity with investors

by Susan Smith

The following is extracted from the Second Quarter 2014 issue of the PwC Real Estate Investor Survey, released on June 16, 2014. The findings and opinions reflect those of the investors surveyed and do not necessarily reflect the views of PwC.

The national student housing market began attracting attention from investors during the recent economic downturn when high growth in high school and early college-age population caused an increase in university enrollments, creating substantial demand for both on-campus and off-campus student housing. Due to a spike in admissions, many students often look to off-campus student housing alternatives, particularly after freshman year. This trend has led to an increase in demand for off-campus student housing alternatives, as well as growing interest among investors and developers to capitalize on such positive leasing shifts.

Traditionally, colleges and universities have preferred to own and operate on-campus student housing facilities while private owners and operators focus on off-campus locations. As a result, many newly developed off-campus student communities are commonly resort-style properties with luxury amenities and high-end finishes. For on-campus student housing, both operating budget constraints at public institutions and increased competitiveness among schools have some universities considering partnerships with the private sector to raise funds for modernizing or replacing outdated on-campus housing. For the investors, these relationships can provide access to land, development projects, and consequently returns on investment that were previously unavailable.

While a larger number of investors have entered this niche market, there are still a relatively small number of players compared to other commercial real estate (CRE) asset types. Thus far in 2014, private buyers represent 55.0% of the buying pool in this sector followed by institutional money at 25.0%, according to data provided by Real Capital Analytics. Three years ago, institutional (43.0%) and private investors (24.0%) were the primary buyers of student housing properties. Even though high occupancies and annual rent growth attract investors to student housing, some investors are concerned about the potential for overbuilding.

At this time, most private investing in the US student housing sector relates to off-campus assets. Therefore, the information contained in the *PwC Real Estate Investor Survey* focuses on that category. This quarter, overall capitalization rates (initial rates of return anticipated by the surveyed investors) range from 5.25% to 7.75% and average 6.45% for the national student housing market. This average is higher than the average for the national apartment market, which operates similarly to the student housing market, as well as the three regional apartment markets in the Survey (see Chart SH-1).

In addition, rent growth expectations for the national student housing market are less aggressive than for three of the four apartment markets in the Survey.

Overall, positive demographic trends relating to student population growth and a greater desire to live off campus are expected for the national student housing market over the next several years, which will likely result in additional capital being placed in this sector, particularly among CRE investors looking for higher yields.

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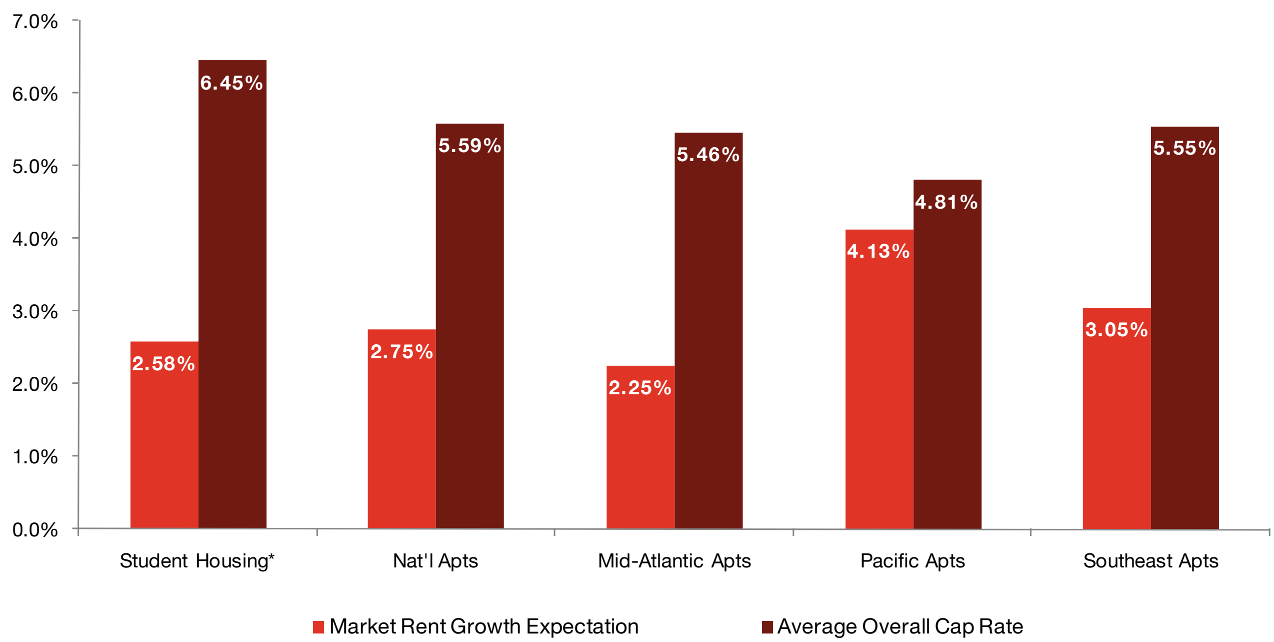
Chart SH-1



Source: *PwC Real Estate Investor Survey*

More information on the PwC Real Estate Investor Survey™ can be found at www.pwc.com/us/realestatesurvey or by calling 1-800-654-3387.

Climate change and real estate
A going concern

by Christoph Gross

After decades of research and countless studies the evidence is clear: the climate is changing. The overwhelming consensus among the scientific community is that climate change can be linked to man-made greenhouse gas ("GHG") emissions,[1] but regardless of whether global warming is anthropogenic or purely a natural phenomenon it is happening all the same. As the effects from global warming are becoming more and more evident, a number of key trends and impacts to the real estate industry are starting to take shape and are expected to be increasingly influential drivers in the sector going forward.

Demand for green buildings

Close to 40% of GHG emissions are attributed to the design, construction and operation of buildings.[2] Given the increasing popularity of the real estate sector's green building product and its ability to deliver cost-effective resource efficiency and conservation solutions, it's evident that the demand for green buildings is only going to increase.[3] Not only will new policies and regulations inevitably put more stringent requirements on emissions levels in the sector, but investor and tenant demand has already started to create a favorable price shift in the direction of green building product.

Per data from the CoStar Group, a commercial real estate information company that tracks approximately 44 billion square feet of commercial space in the US, LEED building economics compare favorably to traditional space, generating rent premiums of $12.25 per square foot, commanding 4.1 percent higher occupancy rates, and transacting for $184 more per square foot.[4] Meanwhile, these types of properties incur no more than a 2.5 percent cost premium upfront to design and build.[4] The economic benefits of reduced operating costs, especially in an environment of future energy cost volatility, are having a noticeable effect on the fundamental drivers of value. Furthermore, although less tangible, the societal benefits of environmental goodwill and occupant health are also key drivers

1 According to the American Association for the Advancement of Science, the world's largest non-government general science membership organization, about 97% of climate scientists have concluded that human-caused climate change is happening. http://whatweknow.aaas.org/get-the-facts/
2 National Institute of Building Sciences, "Greenhouse Gas Emissions in Federal Buildings." http://www.wbdg.org/resources/greenhousegasemissions.php
3 World Green Building Council, "The Business Case for Green Building." http://www.worldgbc.org/files/8313/6324/2676/Business_Case_For_Green_Building_Report_WEB_2013-03-13.pdf
4 Financial Post, "The Financial Case for Green Buildings." http://www.financialpost.com/related/topics/financial+case+green+buildings/2000693/story.html

in the green building movement. This growing trend towards sustainable development is evident from the 2013 World Green Building Trends Report issued by McGraw-Hill Construction. According to the study, 51 percent of respondents are dedicating a majority, greater than 60%, of their new development work to be green by 2015. This is up from the 28% and 13% of firms that reported this activity in 2012 and 2009, respectively.[5]

Increased regulatory pressures

New legislation and initiatives on the federal and state level focusing on sustainability are in a constant state of flux, creating an environment of uncertainty. On October 5, 2009 President Obama signed Executive Order 13514, "Federal Leadership in Environmental, Energy, and Economic Performance" that set sustainability goals for Federal agencies. One such goal focused on sustainable buildings and requires that, beginning in 2020, all federal buildings must be designed to achieve "zero net energy" by 2030. Meanwhile, states have taken the lead in enforcing their own standards that encompass the private sector. International Energy Conservation Codes have been adopted by 47 states which regulate the design and construction of commercial buildings for the effective use and conservation of energy over their useful lives.[6]

Disclosure requirements around climate change have also been a topic of discussion. In January of 2010, the Securities and Exchange Commission voted to require all public companies operating in the US to disclose financial risks and rewards associated with climate change in their filings with the commission. While almost 75 percent of publicly traded companies did not adhere to this requirement in 2013,[7] investors continue to clamor for more and more information on what companies are doing to combat climate change. In the real estate sector in particular, states such as California have paved the way for increased disclosure around the energy efficiency of commercial buildings. The Nonresidential Building Energy Use Disclosure Program implemented this year requires owners and operators to benchmark a building's energy use to Energy Star standards in advance of a sale, lease or financing of a building with more than 5,000 square feet. The goal of the program is to facilitate market access to credible information about a building's energy performance and allow companies to make more informed decisions about the energy efficiency of the office space they buy or rent. This in turn creates a market-based incentive for owners to improve their properties with cost-effective energy efficient upgrades.

Physical impacts from extreme weather

Whether it's rising sea levels and stronger, more frequent storms along the coasts or increased drought and forest fires threatening inland communities, climate change is poised to affect real estate just about everywhere we live. The East Coast is expected to be particularly at high risk primarily due to the fact that the land in some parts of this area is sinking in conjunction with the sea level rising.[8] This is particularly noticeable in the Chesapeake Bay region in cities such as Norfolk, where coastal flooding has become such a severe problem that protecting the city could cost as much as $1 billion and may potentially require some areas to eventually be vacated.[8] In the mid-Atlantic region, where much of the population and economy of the country is concentrated, rising sea levels are compounding the flooding due to tropical storms and cyclones. Hurricane Sandy, for example, wreaked havoc to the tune of $82 billion in damages[9] and could be a harbinger of things to come.

Physical damage caused by extreme weather is inevitably going to lead to higher operating costs in the form of capital expenditures and insurance premiums. Re-zoning could occur in many areas as local governments weigh the risks of future developments and people will need to decide whether buying or rebuilding in certain areas is worth the risk.

Insurance industry adjustments

One of the most immediate ways climate change could affect real estate is through a rise in insurance rates and premiums. In 2011 insurers responded to 99 weather-related disaster declarations in the US, exceeding the previous record of 81 set in 2010.[10] Despite the increased frequency of more extreme weather events, it appears that many US insurance companies could be ill-prepared. According to a report from Ceres, a coalition of investors, companies and public interest groups advocating

5 McGraw-Hill Construction, "World Green Building Trends SmartMarket Report: Business Imperative and Market Demand Driving Green Building Growth." http://construction.com/about-us/press/world-green-building-trends-smartmarket-report.asp
6 International Code Council. http://www.iccsafe.org/gr/Pages/adoptions.aspx
7 Inside Climate News, "Most US Companies Ignoring SEC Rule to Disclose Climate Risks." http://insideclimatenews.org/news/20130919/most-us-companies-ignoring-sec-rule-disclose-climate-risks
8 New York Times, "The Flood Next Time." http://www.nytimes.com/2014/01/14/science/earth/grappling-with-sea-level-rise-sooner-not-later.html?hp&_r=1
9 New York Times, "Congress Approves $51 Billion in Aid for Hurricane Victims." http://www.nytimes.com/2013/01/29/nyregion/congress-gives-final-approval-to-hurricane-sandy-aid.html?_r=0
10 AIG, "Climate Change: A Call for Weatherproofing the Insurance Industry." http://www.aig.com/Chartis/internet/US/en/IPG%20Real%20Estate%20Climate%20Change%20Paper_tcm3171-488915.pdf

sustainability leadership, many companies are "only just beginning to address the effects climate change may have on their businesses."[11] Per the 184 insurance company disclosures reviewed for the 2012 Insurer Climate Risk Disclosure Survey only 23 have comprehensive strategies in place to deal with the impacts of climate change.[11]

This is a worrisome trend as a failure of the insurance industry to adapt could impact large numbers of consumers and businesses by leaving them unable to secure private insurance, especially in high-risk geographic areas. Under this scenario, federal, state and local governments may have to step in as insurers of last resort with taxpayers essentially subsidizing the riskiest properties. This trend has already begun in areas such as South Florida and other hurricane-exposed areas where government exposure rose to a record $885 billion in 2011, a 15-fold increase from 1990 levels.[12] In addition, a new mandate from Congress requires future federal flood maps to take projected sea-level rise into account. If insurance rates start to reflect the evolving risks of climate change properties more susceptible to these risks are poised to lose value and riskier developments may be discouraged altogether, as discussed by a panel of real estate, finance and insurance professionals at the Fifth Annual Southeast Florida Regional Climate Leadership Summit.[13]

Investor considerations

The commercial real estate sector is beginning to take climate change into account when making investment decisions and assessing overall business risk. In fact, according to the 2013 Global Investor Survey on Climate Change, about 81 percent of asset owners and 68 percent of asset managers said they view climate change as a material risk across their entire investment portfolio.[14] Furthermore, per the survey, more than half of asset managers and almost a quarter of asset owners claimed that climate change concerns influenced their investment or divestment decisions.[14]

However, despite all the heightened attention to climate change among the investment community, it has not appeared to influence capital investment in areas exposed to increased levels of environmental risk. In Miami for example, the subject of a 2013 article by Rolling Stone focused on the susceptibility of the city to rising sea and storm levels,[15] the average price of commercial real estate rose by over 7% in the first quarter of 2014 (compared to the prior year).[16] Similarly, home prices in the area rose by approximately 19% during the same time period.[17]

The apparent incongruence between real estate values and relative exposure to climate change risks is most likely attributed to a number of factors. The uncertainty around the severity and timing of global warming consequences and the lack of overall acceptance by the public are key considerations. Furthermore, the presumption could be that the effects of global warming are not at all insurmountable and that we will inevitably come up with adequate and cost-effective solutions to protect our assets. In any case, more companies are acknowledging a need to factor climate change into their business planning and as the risks of holding onto real estate in certain areas noticeably increases, pricing will most likely reflect this.

Conclusion

Planning for the unknown is always a difficult undertaking. Businesses, particularly those in the real estate industry, are facing a number of dynamic challenges that are being driven by the increased focus on climate change. Investors and owners who are better able to understand climate and sustainability risks and opportunities could get a leg up on the competition and be better positioned for the future.

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11 Ceres, "Insurer Climate Risk Disclosure Survey 2012." http://www.ceres.org/resources/reports/naic-report/view
12 Insurance Information Institute, "Residual Market Plans: From Markets of Last resort to Markets of First Choice-2012." http://www.iii.org/sites/default/files/ResidualMarketWhitePaper-2012.pdf
13 Sun Sentinel, "Rising seas haven't hurt property values – yet." http://articles.sun-sentinel.com/2013-11-08/news/fl-climate-real-estate-20131108_1_estate-market-real-estate-values-property-values
14 The 2013 Global Investor Survey on Climate Change was commissioned by the Global Investor Coalition on Climate Change and was based on responses from 84 investors representing more than $14 trillion in assets
15 Rolling Stone, "Goodbye Miami." http://www.rollingstone.com/politics/news/why-the-city-of-miami-is-doomed-to-drown-20130620
16 Based on data from NACREIF
17 CNBC, "Is Miami the next Monaco?" http://www.cnbc.com/id/101592842

New revenue recognition standard and impact to the real estate industry

by Bill Staffieri

Update

On May 28, 2014, the FASB and IASB (the "boards") released their new standard, *Revenue from Contracts with Customers*. The objective of the revenue standard is to provide a single, comprehensive revenue recognition model for certain contracts with customers to improve comparability within industries, across industries, and across capital markets.

What are the key provisions?

The revenue standard contains principles that an entity will apply to determine the measurement of revenue and timing of when it is recognized. The underlying goal is for an entity to recognize revenue as it transfers goods or services to customers at an amount that the entity expects to be entitled to in exchange for those goods or services.

Entities will follow a five-step approach to apply the standard:

- **Step 1**: Identify the contract(s) with the customer;
- **Step 2**: Identify the separate performance obligations in the contract(s);
- **Step 3**: Determine the transaction price;
- **Step 4**: Allocate the transaction price; and
- **Step 5**: Recognize revenue when a performance obligation is satisfied.

For real estate, there are certain steps that may be of critical importance. For example, identifying a contract with a customer will be very important for determining the appropriate derecognition model to apply for sales of real estate. Also, the proper identification of the customer and performance obligations included within fee arrangements will be an important consideration for real estate funds.

Scope

The revenue standard applies to contracts with customers, noting that certain contracts are scoped out. For real estate, the new standard will apply to sales of real estate (either a business or an asset) to customers. The new standard will also apply to property management fees, construction or development fees, leasing commissions and other types of fee income commonly present in real estate arrangements.

Sales of property, plant and equipment, operating property and investment property are generally not considered "revenue from contracts with customers" or an output of an entity's ordinary activities. Transfers of non-financial assets (considered a business) that are not an output of an entity's ordinary activities (e.g., sale of real estate to a non-customer) are not within the scope of the revenue recognition standard. For transfers of non-financial assets (considered an asset) to non-customers, an entity must apply portions of the guidance from the new revenue standard.

If derecognition treatment is appropriate (e.g., the seller lost control of a business or the seller transferred control of an asset), these transactions generally result in non-operating gain or loss recognition rather than revenue.

What is the impact on real estate entities?

The most significant impact to the real estate industry is expected to be revenue recognition related to sales of real estate and real estate asset management, as discussed below.

Sales of real estate

The new revenue standard (or portions of it) will apply to (i) transfers of a non-financial asset to a customer (either a business or an asset) and (ii) transfers of a non-financial asset that is considered an asset and not an output of an entity's ordinary activities. Only transfers of a non-financial asset (considered a business) to a non-customer will be outside of the scope of the new revenue guidance. In that case, the FASB decided that an entity should apply existing deconsolidation guidance in ASC 810-10 instead of the current derecognition model applied to real estate sales in ASC 360. Derecognition or timing of income recognition might differ depending on the guidance applied.

The nature of sales of real estate will need to be evaluated to determine if the sales will represent sales of assets or businesses to customers or non-customers. Significant judgment will be required to determine if the sale of real estate constitutes an asset or a business.

Under the new revenue standard, some sales of real estate may be recognized earlier as the new standard eliminates the prescriptive requirements to recognize full profit on a sale of real estate. Under the new standard, collectability, contract enforceability and control conveyance will be the key factors in determining whether the contract exists and the sale has occurred.

The appropriate revenue recognition model to apply depends on which type of sale of real estate exists, which are discussed in further detail below.

Sales of real estate to customers

Sales of real estate (businesses and assets) to customers in the ordinary course of business (e.g., timeshares, condominiums, homebuilding, etc.) will apply the new revenue recognition standard to the entire transaction. These entities are expected to be the most significantly impacted by the new standard.

Sales of real estate (asset sales) to non-customers

Sales of real estate outside of the ordinary course of business (non-customers) that does not constitute a business (e.g., sale of vacant building or empty land lot) will apply the requirements from the new standard to determine: (i) If a contract exists and the parties are committed to perform under the contract; (ii) If control of the asset has transferred to the buyer; and (iii) The measurement of the gain or loss to recognize when the asset is derecognized including any constraint on income due to variable consideration.

Sales of real estate (businesses) to non-customers

Sales of real estate that constitute a business will apply the derecognition model in the consolidation rules in ASC 810-10 to determine if control of the business has been conveyed to the buyer (Note: ASC 810 has been modified to no longer scope out sales of real estate).

Partial sales of real estate

Sales of real estate (businesses and assets) to a joint venture to be accounted for as an equity method investment (e.g., seller retains interest but does not control the joint venture) are considered “partial sales.” The appropriate accounting model to apply to the partial sale will depend on if the transaction represents a partial sale of a business or asset. The derecognition model in the consolidation rules in ASC 810-10 or the partial sale model in the nonmonetary transaction rules in ASC 845 may need to be considered.

Real estate asset management

Revenue recognition in the real estate asset management industry can be complex as there are many variations of investment structures aimed at achieving returns or investment income for investors. Asset managers will now recognize revenue it expects to be entitled to, subject to a constraint. The constraint would limit the amount of consideration that may be recognized to the amount that is probable of not being subject to a significant revenue reversal in future periods.

Areas of change will vary depending on existing policies; a higher likelihood of changes may occur with upfront fees which may now be deferred in some cases, upfront costs, and performance based fees. Some of the key issues companies will need to consider include identifying who the ultimate “customer” is, and how to identify the distinct performance obligations.

Identifying the contract with the customer has ramifications throughout the revenue model and might significantly affect how the standard is applied. Two views exist regarding which party is the customer, the fund or the investor. This judgment is important when it comes to identifying the performance obligation(s) and timing of revenue recognition.

Another key question that impacts the timing of revenue recognition is whether there are multiple performance obligations or just one. Once that is answered, management must determine the amount of the transaction price at contract inception and at each reporting date. The entity will recognize revenue as the performance obligation is satisfied. If the amount it expects to be entitled to is variable, the variable consideration included in the transaction price would be limited to the amount that is “probable” of not resulting in a significant revenue reversal in the future.

Management fees for real estate funds are usually based on net assets under management, while performance fees are usually based on profits generated from the underlying investments held by funds subject to certain thresholds (e.g., internal rate of return). As such, management fees and performance fees constitute what is referred to in the new standard as variable consideration.

Disclosures

The revenue standard requires a number of disclosures intended to enable users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and the related cash flows. The disclosures include qualitative and quantitative information about contracts with customers, significant judgments made in applying the revenue guidance, and assets recognized from the costs to obtain or fulfill a contract. The disclosure requirements are significantly greater than existing disclosure requirements for revenue.

What’s next?

Entities will apply the revenue standard in the first interim period within annual reporting periods beginning on or after December 15, 2016 (US GAAP public entities) and January 1, 2017 (IFRS). Earlier adoption is not permitted under US GAAP, but is permitted under IFRS. The standard will be effective for annual reporting periods beginning after December 15, 2017 for nonpublic entities (US GAAP only). Earlier application is permitted for nonpublic entities; however, no earlier than the effective date for public entities. Nonpublic entities will be required to apply the new standard to interim periods within annual reporting period beginning after December 15, 2018.

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REIT investments in excess mortgage servicing rights

by James Guiry

The Internal Revenue Service ("IRS") has issued two private letter rulings to real estate investment trusts ("REITs") that are likely to have a significant effect on the role played by mortgage REITs in the mortgage debt market.[1] The letter rulings are addressed to REITs intending to invest in excess mortgage servicing rights and provide clarity regarding issues that might otherwise have deterred REITs from making such investments.[2]

Background

Mortgage loan originators often sell pools of originated mortgage loans. The buyers of mortgage loans may service the mortgage loans themselves or enter into a servicing agreement with respect to the loans. In consideration for performing mortgage servicing activities, a servicer will generally retain the right to receive a portion of the interest payments made by the borrowers with respect to the pool of mortgages being serviced ("Mortgage Servicing Right"). A portion of the Mortgage Servicing Right will be treated by the servicer as reasonable compensation for services performed ("Normal Servicing Right"). However, the portion of the Mortgage Servicing Right that exceeds reasonable compensation for services (the "Excess Servicing Right") represents a continuing investment in the interest component of the underlying mortgage pool.[3]

Mortgage loan originators and servicers may wish to sell all or a portion of its Excess Servicing Right for any of a number of reasons, including changing business models, financing needs, and regulatory capital requirements. Mortgage REITs seeking to diversify their investments may wish to acquire Excess Servicing Rights. However, a REIT interested in acquiring an Excess Servicing Right must consider how such an investment would be treated under the rules which determine whether an entity qualifies as a REIT.

The rules which determine whether an entity qualifies as a REIT are set forth in section 856 through section 860 of the Internal Revenue Code ("Code"). Among those rules, the following sections of the Code are particularly relevant to a REIT considering investing in Excess Servicing Rights:

1 PLR 201234006 (May 24, 2012) and PLR 201328018 (April 12, 2013).

2 Other REITs may not rely on these private letter rulings as precedent. However, the rulings do provide insight into the IRS' views on the issues presented, and it is with that in mind that we present the following discussion of the rulings.

3 See, e.g., section 4.02 of Rev. Proc. 91-50, 1991-2 C.B. 778.

1. Section 856(c)(2) provides that at least 95 percent of a REIT's gross income must be derived from sources that include interest;
2. Section 856(c)(3) provides that at least 75 percent of a REIT's gross income must be derived from sources including interest on obligations secured by mortgages on real property or on interests in real property;
3. Section 856(c)(4) provides that at least 75 percent of the value of a REIT's assets must be represented by real estate assets, cash or cash items, or Government securities; and
4. Section 856(c)(5)(B) provides that the term real estate assets includes interests in mortgages on real property.

The status of Excess Servicing Rights under section 856 has been an issue much debated within the REIT community. Certain guidance provided by the IRS with respect to Excess Servicing Rights in other areas suggested that an Excess Servicing Right might be treated as an interest in a mortgage on real property and, thus, a real estate asset under section 856(c)(5)(B) and that the income from an Excess Servicing Right might be treated as interest on an obligation secured by mortgages on real property under section 856(c)(2) and (3). Specifically, in Rev. Rul. 91-46, the IRS considered the application of the coupon stripping rules of section 1286 to Excess Servicing Rights and ruled that an Excess Servicing Right is treated as a stripped coupon under section 1286. As discussed further below, Rev. Rul. 91-46 laid the foundation for the favorable letter rulings recently issued by the IRS.

Rev. Rul. 91-46 concerned a taxpayer in the business of originating and servicing mortgages. When it sold or otherwise transferred a pool of mortgages to a purchaser, the taxpayer entered into a contract to service the mortgages. The mortgage servicing contract provided that the taxpayer was entitled to receive amounts from interest payments collected on the mortgages in an amount that was greater than the minimum annual amount allowable for normal servicing of mortgages of the type sold by the taxpayer.

In the ruling the IRS analyzed the transaction as follows:

1. To the extent that the taxpayer's rights to receive amounts under the mortgage servicing contract represented rights to receive reasonable compensation for services to be performed under the contract, they would be treated as rights to receive compensation from the purchaser.
2. However, to the extent that the contract entitled the taxpayer to receive amounts in excess of reasonable compensation for services, the taxpayer's rights to receive amounts from interest payments collected on the mortgages would be treated as "coupons" under section 1286(e)(5), which defines the term "coupon" to include any right to receive interest on a bond, debenture, note, certificate, or other evidence of indebtedness.
3. When the taxpayer sold mortgages to the purchaser and entered into the mortgage servicing contract, the transaction resulted in a separation in ownership between the mortgages and rights to receive some of the interest payable in the future on those mortgages.
4. Thus, the taxpayer's transaction caused the purchased mortgages to become "stripped bonds" under section 1286(e)(2) and the coupons held by the taxpayer to become "stripped coupons" within the meaning of section 1286(e)(3).

Based on the foregoing analysis, the IRS ruled that if a taxpayer sells mortgages and at the same time enters into a contract to service the mortgages for amounts received from interest payments on the mortgages, and if the contract entitles the taxpayer to receive amounts that exceed reasonable compensation for the services to be performed, then the mortgages are "stripped bonds" within the meaning of section 1286(e)(2), and the taxpayer's rights to receive the excess amounts under the contract are "stripped coupons" within the meaning of section 1286(e)(3). Further, to the extent the amounts received by the taxpayer are treated as payments with respect to "stripped coupons" such payments are treated as received directly by the taxpayer from the mortgagors.

By treating the Excess Servicing Right as a right to receive interest income on the underlying mortgage loans, the IRS laid the foundation for treating an Excess Servicing Right as an interest in a mortgage on real property and, thus, a real estate asset under section 856(c)(5)(B) and for treating the income from an Excess Servicing Right as interest on an obligation secured by mortgages on real property under section 856(c)(2) and (3). However, the IRS had not ruled on that issue until recently when in successive years it issued PLR 201234006 (May 24, 2012) and PLR 201328018 (April 12, 2013). These rulings build on the foundation provided by Rev. Rul. 91-46.

4 Rev. Rul. 91-46, 1991-2 C.B. 358.

PLR 201234006 (“2012 PLR”)

Facts

The 2012 PLR concerned a REIT that intended to acquire Excess Servicing Rights pursuant to two types of acquisition agreements. Under the first type of acquisition agreement, the REIT would acquire Excess Servicing Rights that exist at the time the acquisition agreement is entered into (“Current Servicing Agreement”). Under the second type of acquisition agreement, the REIT would have the right or obligation to acquire, and the relevant selling servicer would have the right or obligation to sell, Excess Servicing Rights that would be created in connection with loan origination and securitization transactions that take place in the future (“Future Servicing Agreement”).

The ruling stated that the Future Servicing Agreement might relate either to refinancings of existing mortgages that underlie Excess Servicing Rights owned by the REIT or to entirely new mortgages with new borrowers. A Future Servicing Agreement might require the REIT to pay all or a portion of the purchase price for the Excess Servicing Right at the time the Future Servicing Agreement is entered into, or a Future Servicing Agreement might require the REIT to pay for the Excess Servicing Right at the time it is acquired by the REIT, based on a price that is determined either at that time or that is fixed at the time the Future Servicing Agreement is entered into. In cases in which the amount paid or to be paid by the REIT for the Excess Servicing Right is fixed at the time a Future Service Agreement is entered into, the price will reflect the parties’ expectations regarding interest rates, the level of future loan origination and refinancing activity, and other economic factors, including the health of the economy in general and the real estate market in particular.

The ruling also stated that the REIT’s right to receive payments with respect to the Excess Servicing Rights might be senior to, subordinate to, or *pari passu* with the servicer’s right to receive the portion of the Mortgage Servicing Rights owned by the servicer. Thus, if the borrowers on the underlying mortgage loans did not pay the full amount of interest due on those loans, the amount received by the REIT would vary depending on the amount of interest paid by the borrowers and the priority scheme adopted with respect to the particular Excess Servicing Right to which those mortgage loans relate.

In certain cases, the servicer would be required to make advances of principal and interest to investors. As explained in the ruling, such servicer advances are customary features of certain types of mortgage pools and are designed to ensure that payments received by investors with respect to a pool of mortgages are level from month to month, not taking into account prepayments or foreclosures. Thus, if a handful of borrowers in a mortgage pool fail to make their monthly mortgage payments on time, servicer advances may prevent those late payments from causing undue variations in the investors’ payment streams. Servicer advances are made with the expectation that they will be repaid in full, and a servicer’s right to repayment of a servicer advance ranks senior to the right of investors to receive other payments on the underlying mortgages, including amounts received upon foreclosure or liquidation.

According to each agreement entered into by REIT, the servicer would be required to perform all mortgage servicing activities with respect to the underlying mortgage loans. The REIT would not be required or permitted to perform any services in order to acquire or maintain its interest in an Excess Servicing Right. Additionally, the REIT would have no right to control the manner in which the underlying mortgage loans were serviced.

Termination of the servicer for cause would terminate the REIT’s rights with respect to the Excess Servicing Right. If, however, the servicer were terminated other than for cause, both the REIT and the servicer would receive a termination payment in accordance with their respective interests.

The ruling noted as a final point that the REIT’s ownership of an Excess Servicing Right did not provide the REIT with any rights with respect to any income earned by any servicer or any of its affiliates from any other source.

IRS analysis

In determining how the Excess Servicing Right is treated under section 856, the IRS started its analysis with Rev. Rul. 91-46 wherein as noted above the IRS ruled that an Excess Servicing Right is treated as a coupon under section 1286(e)(5) giving rise to the right to receive interest income. The IRS continued by noting that the amount to be received by the REIT from the Excess Servicing Rights at issue in the ruling would be based on a fixed percentage of the outstanding principal amounts of the serviced mortgages, and would not be renegotiated during the term of the service contract. Therefore, the IRS concluded that the amounts received by the REIT from the Excess Servicing Right would not depend in whole or in part on the income or profits of the servicer. Importantly, the IRS concluded that termination of the servicer for cause was a remote contingency and, therefore, did not adversely affect the characterization of the Excess Servicing Right under section 856, even though should such an event occur the REIT would not receive any interest income on the Excess Servicing Right.

Turning to the Future Servicing Agreement, the IRS concluded that the classification of an asset is not affected by the manner in which that asset is acquired, and, specifically, is not affected by the fact that it was acquired pursuant to a prior agreement. The IRS used as an analogy the fact that a parcel of real property that is a real estate asset within the meaning of section 856(c) does not cease to be a real estate asset if the REIT agreed to acquire the property before closing on the acquisition. Thus, the IRS found that the fact that the REIT might acquire certain of its Excess Servicing Rights pursuant to one or more Future Servicing Agreements did not change the characterization of the Excess Servicing Rights for purposes of the asset and income tests in section 856.

Addressing the fact that the REIT's rights to receive payments in respect of an Excess Servicing Right might be subordinate to, senior to, or *pari passu* with the servicer's rights to receive a portion of the Mortgage Servicing Right, the IRS pointed out that neither section 856(c) nor Rev. Rul. 91-46 distinguishes between junior and senior interest in mortgages and that contingency of priority in receiving income is not relevant to the analysis of the characterization of the income to be received. Thus, the IRS concluded that a priority in receiving payments did not alter the tax classification of the Excess Servicing Right as an ownership interest in the underlying mortgage loans for purposes of section 856.

With respect to the servicer advances, the IRS regarded these as a form of credit enhancement that did not alter the character of the interest income received by the REIT.

IRS ruling

In accordance with the foregoing analysis, the IRS ruled that the Excess Servicing Right acquired by the REIT is an interest in mortgages on real property and thus a real estate asset for purposes of section 856(c)(5)(B), and further that interest income received by the REIT from the Excess Servicing Right will be considered as derived from interest on obligations secured by mortgages on real property for purposes of section 856(c)(3)(B).

The IRS specified that it expressed no opinion regarding whether the servicer properly characterized the amounts acquired by the REIT as excess servicing (and therefore treated as stripped coupons) or whether either section 1286 or Rev. Rul. 91-46 was properly applied to such amounts.

PLR 201328018 ("2013 PLR")

Facts

As in the 2012 PLR, the 2013 PLR concerned a transaction in which a REIT would acquire an Excess Servicing Right. However, unlike the 2012 PLR, the ruling involved a two-step transaction in which a Taxable REIT Subsidiary ("TRS") of the REIT would acquire a Mortgage Servicing Right consisting of both the Excess Servicing Right and the Normal Servicing Right associated with a portfolio of mortgage loans and then sell the Excess Servicing Right to the REIT on an arm's length fair market value basis. The TRS would retain the Normal Servicing Right and engage an unrelated third-party subservicer to service the mortgage loans in the portfolio. A portion of the Normal Servicing Right would be used by the TRS to pay the subservicer its fee for servicing the mortgages loans.

As in the 2012 PLR, the REIT would not have any obligation or duty with respect to servicing the underlying mortgages. Additionally, as in the 2012 PLR, the REIT would have no right to control the manner in which the underlying mortgage loans were serviced. As the owner of the Excess Servicing Right, the REIT would receive payments directly from the servicer from the interest on the mortgage payments made by the mortgage borrowers.

As in the 2012 PLR, the right of the REIT to receive payments with respect to the Excess Servicing Right might be senior to, subordinate to, or *pari passu* with the servicer's right to receive all or a portion of the Normal Servicing Right. Accordingly, the amount of income from the Excess Servicing Right received by the REIT would vary depending on the amount of interest collected on the mortgage loans and the priority scheme adopted with respect to those mortgages.

The effects of a termination of the servicer on the REIT's right to payment on the Excess Servicing Right were similar to the effects described in the 2012 PLR.

IRS analysis

The IRS analysis followed the same line of reasoning as set forth in the 2012 PLR, thus reinforcing the basis for treating an Excess Servicing Right as an interest in mortgages on real property and thus a real estate asset for purposes of section 856(c)(5)(B), and for treating the interest income received by the REIT from an Excess Servicing Right as interest on obligations secured by mortgages on real property for purposes of section 856(c)(3)(B).

IRS ruling

The ruling issued by the IRS is identical to the ruling issued in the 2012 PLR except for the fact that the IRS explicitly based its ruling in the 2013 PLR on an assumption that the Excess Servicing Right acquired by the REIT is properly treated as a stripped coupon under section 1286.

Summary

Taken together the 2012 PLR and the 2013 PLR highlight the importance of the following points in connection with the treatment of mortgage servicing rights acquired by a REIT:

1. The portion of the mortgage servicing fee that exceeds reasonable compensation for the services required to be performed by the servicer (i.e., the excess servicing right) is treated as a right to receive interest income on the underlying mortgage loans.
2. The right to receive interest income on the underlying mortgage loans represented by the excess servicing right constitutes a real estate asset under section 856(c)(5)(B) and the income earned on the excess servicing right is qualifying interest income under section 856(c)(2) and (3).[5]
3. Whether the REIT acquires an excess servicing right with respect to a current pool of mortgage loans or a future pool of mortgage loans, the right may be treated as a real estate asset under section 856(c)(5)(B) when acquired.
4. In neither the 2012 PLR nor the 2013 PLR did the IRS rule on whether the excess servicing constituted a stripped coupon under section 1286 and Rev. Rul. 91-46, thus underscoring the point that determining the amount of reasonable compensation for services is critical to distinguishing excess servicing rights from normal servicing rights.
5. In determining whether a transaction constitutes the acquisition of an excess servicing right as opposed to the formation of a joint venture to perform services with as servicer, the following factors appear to be significant: the servicer must be required to perform all mortgage servicing activities with respect to the underlying mortgages; the REIT must not control the manner in which the servicer provides its services; and the REIT must not be allowed to perform any services with respect to the underlying mortgages.
6. Provided that a REIT and its TRS engage in transactions on an arm's length basis, a TRS may acquire normal servicing rights with respect to a pool of mortgage loans with respect to which the REIT has acquired the excess servicing rights.

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5 Although not discussed in either ruling, the qualification of the excess servicing right as real estate asset generating qualifying real estate interest income under section 856(c) may depend on whether the underlying mortgage loan is itself a qualifying real estate asset generating qualifying income at the time the excess servicing right is created. See, e.g., Rev. Proc. 2011-16.

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