Current Developments for the Real Estate Industry

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What happened?

On February 25, 2016, the FASB issued its long-awaited revision to lease accounting. There are elements of the new standard that could impact almost all entities to some extent, although lessees will likely see the most significant changes.

The IASB issued its new lease accounting standard on January 13, 2016, with some significant points of divergence from US GAAP. Despite the differences, both Boards noted that their respective standards fulfill the key objectives of lessee recognition of lease-related assets and liabilities on the balance sheet and enhanced transparency.

What are the key provisions?

Lessee accounting model

Lessees will need to recognize a right-of-use asset and a lease liability for virtually all of their leases (other than leases that meet the definition of a short-term lease). The liability will be equal to the present value of lease payments. The asset will be based on the liability, subject to adjustment, such as for initial direct costs. For income statement purposes, the FASB retained a dual model, requiring leases to be classified as either operating or finance. Operating leases will result in straight-line expense (similar to current operating leases) while finance leases will result in a front-loaded expense pattern (similar to current capital leases). Classification will be based on criteria that are largely similar to those applied in current lease accounting, but without explicit bright lines.

Lessor accounting model

Lessor accounting is similar to the current model, but updated to align with certain changes to the lessee model (e.g., certain definitions, such as initial direct costs, have been updated) and the new revenue recognition standard. Similar to today, lessors will classify leases as operating, direct financing, or sales-type. Leveraged lease accounting has been eliminated, although grandfathered for existing arrangements.

Embedded leases

An arrangement contains an embedded lease if property, plant, or equipment is explicitly or implicitly identified and its use is controlled by the customer. This differs in certain respects from today's risks and rewards model and may result in the identification of fewer embedded leases compared to the current guidance.

Lease term, variable lease payment, discount rate, incentives

Lease accounting will continue to require significant judgments, including when making estimates related to the lease term, lease payments, and discount rate. Similar to today, the term of the lease will include the non-cancellable lease term plus renewal periods that are reasonably certain of exercise by the lessee or within the control of the lessor.

Reassessment (excluding modifications)

In certain circumstances, the lessee is required to re-measure the lease payments. Re-measurement of the lease payment may be triggered by a reassessment of the lease term. The lease term is required to be reassessed when, for example, the lessee elects to exercise or not exercise an option contrary to initial expectation. Re-measurement is also required when, for example, the contingency associated with a variable lease payment is subsequently resolved such that the variable lease payment now meets the definition of a lease payment or when there is a change in the amounts probable of being paid by the lessee under a residual value guarantee.

When the lessee re-measures the lease payments, variable lease payments based on a rate or index will need to be re-measured.

Re-measurement of the lease payments requires a re-measurement of the lease liability. When re-measuring the lease liability, the lessee is required to use an updated discount rate, except in specified circumstances. A lessor will not be permitted to reassess its determination of lease term, variable rent, or discount rate.

The re-measurement to the lease liability results in an adjustment to the right-of-use asset until it is reduced to zero, after which any remaining adjustment is recorded in the income statement.

Sale-leaseback transactions

Existing sale-leaseback guidance, including guidance applicable to real estate, is replaced with a new model applicable to both lessees and lessors. A sale-leaseback transaction will qualify as a sale only if (1) it meets the sale guidance in the new revenue recognition standard, (2) the leaseback is not a finance lease or a sales-type lease, and (3) a repurchase option, if any, is priced at the asset's fair value at the time of exercise and the asset is not specialized. If the transaction fails sale treatment, the buyer and seller will reflect it as a financing.

Disclosures

Extensive quantitative and qualitative disclosures, including significant judgments made by management, will be required to provide greater insight into the extent of revenue and expense recognized and expected to be recognized from existing contracts.

Effective date and transition

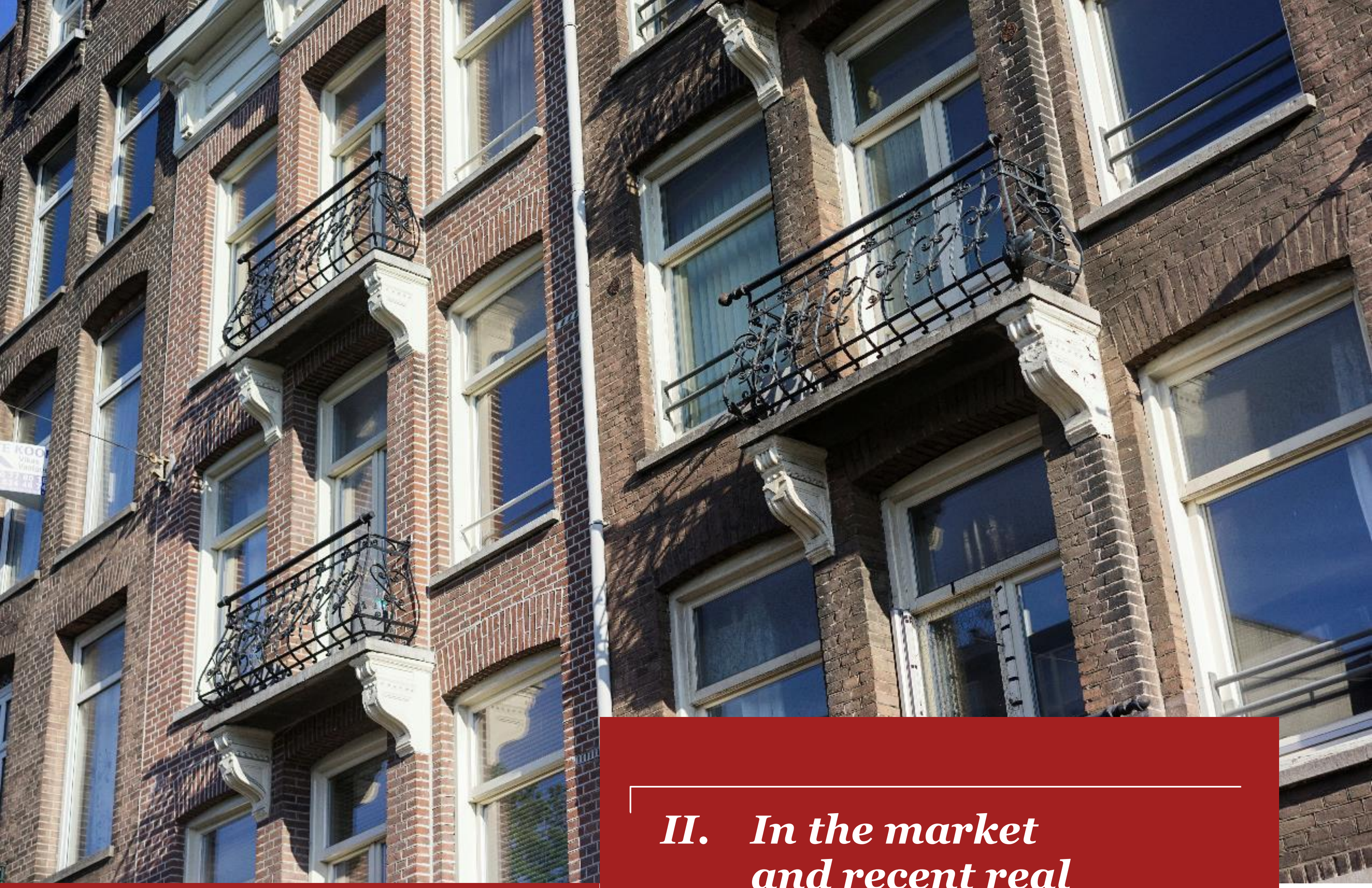
The standard is effective for US GAAP public companies for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. For private companies (i.e., those not meeting the FASB's definition of a public business entity), the standard is effective for fiscal years beginning after December 15, 2019 and interim periods beginning the following year. Early adoption is permitted. The new standard must be adopted using a modified retrospective transition, and provides for certain practical expedients. Transition will require application of the new guidance at the beginning of the earliest comparative period presented.

Why is this important?

Since lessees will be required to reflect virtually all leases on their balance sheet, they will need to ensure that they have an appropriate process to gather and report their leases. A first step is ensuring that their inventory of leases is complete and accurate. Leases may be embedded in service arrangements or provided alongside other goods or services. This process may take considerable time and effort, depending on the volume, complexity, availability of existing data and system capabilities, and level of decentralization within an organization. In addition to the impact on transition, the ongoing financial reporting and expanded disclosures under the new standard may require modification to existing systems and processes. Transition to the new standard will have impacts beyond just financial reporting that should be considered when developing a transition strategy. As a result of changes to the balance sheet, transition may impact debt covenants, apportionment of income for state taxes, and lease versus buy decision making.

Please refer to PwC's In-depth and Lease Accounting Webcast for additional information surrounding the arrival of the FASB's new leasing standard. Further, refer to PwC's In-brief to learn more about the IASB's new standard on leasing.

PwC has also prepared a comprehensive guide to the new US GAAP lease guidance. Please refer to the PwC Lease guide – 2016 edition for additional reference.



II. In the market and recent real estate trends

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6 hot topics at REITWise 2016

In April, PwC was joined in the nation's capital by hundreds of clients and friends at REITWise 2016: NAREIT's Law, Accounting & Finance Conference. The annual conference gives real estate professionals an opportunity to gather to discuss the current political, economic and market events that impact legal, financial, tax and accounting operations within REITs and publicly traded real estate companies. This year's conference drew the largest attendance of any past REITWise conference.

PwC has written a blog discussing several of the particularly interesting topics from the event, including;

- State of the real estate capital markets- IPO and potential M&A activity
- Interest rates and financing
- Accounting and reporting
- Non-traded REITs
- FIRPTA foreign inflows
- Tax reform

Please refer to the PwC Asset Management blog for additional reference.

Emerging trends in European real estate 2016

Capital flows and city rankings will always attract the headlines, but this year Emerging Trends Europe shines a spotlight on fundamental changes at the business end of the real estate industry. It reveals an industry trying to come to terms with the needs of occupiers and the disruptive forces of technology, demographics, social change and rapid urbanization.

These ground level disruptions are permeating through the entire real estate value chain. Investors are focused on cities and assets rather than countries. They also favor alternative, more operational assets for accessing outperformance, with 41 percent of respondents against 28 percent last year considering taking the plunge into alternatives. Healthcare, hotels, student accommodation and data centers are all expected to shine as sectors benefiting from urbanization and long term demographic trends.

Development is seen as another way to achieve outperformance in 2016, with 78 percent agreeing it is an attractive way to acquire prime assets. The more progressive developers and investors are innovating – attempting to anticipate and adapt to rapidly changing occupier demands. Those canvassed by Emerging Trends Europe hold polarized views on issues like optimal lease lengths, shared office space and the impact on established valuation models and traditional assessments.

To learn more about recent trends in European real estate, please refer to PwC's Emerging Trends in Real Estate; Europe 2016 Beyond the capital.

Is additional shareholder value tied up in your real estate?

Many companies have been reconsidering their domestic and global real estate strategies, looking to free up capital or unlock shareholder value. Common real estate monetization strategies include non-recourse financing, sale-leaseback transactions, and REIT conversion or spin-offs. Real estate driven M&A and pressure from activist investors are two factors contributing to strong growth in the market for monetized assets. What's thought of as "real estate" is expanding beyond the traditional definition, to include assets like billboards, cell towers, and utility/ telecom infrastructure.

Please refer to PwC's February 2016 In the loop to learn more about potential real estate monetization strategies for your company.

Through the looking glass; emerging trends in real estate Asia Pacific 2016

Asia's real estate markets are the product of almost eight years of easy money from the world's central banks. Easing in the United States may have ended, but both Japan and the European Union continue to provide liquidity, while interest rates in many Asian countries are now lower than they were a year ago. With both local and global institutional investors also allocating more capital to the sector, the result is more money chasing fewer assets, pushing prices up across most markets and sectors even as the current cycle appears increasingly long in the tooth.

As the bull market in Asian real estate enters its seventh year, both pricing and yields continue to tighten across most markets, creating a feel-good factor for many fund managers as they look to sell assets purchased years ago in the wake of the global financial crisis. However, while that gambit has now proved a profitable trade, the outlook for more recent purchases seems less of a sure thing. Regional economies are generally weak, exports are down, and currencies are depreciating. On top of that, today's ultra-compressed yields have taken prices to rarefied levels, suggesting we may be approaching a cyclical peak.

To read more about the Asia Pacific real estate market and emerging trends, please refer to PwC's Emerging Trends in Real Estate Asia Pacific 2016.

Huge expansions in cities, with mixed results

By 2020, the 21st century's great migration to the cities will be well underway. Cities will be swelling across the fast-growing countries in Asia, Africa, the Middle East and Latin America. Even the developed Western nations will be urbanizing, albeit at a slower pace. But not all cities will prosper. While some become great centers of wealth creation in a multipolar world, others are likely to fail.

The volume of building activity will be huge, expanding the world's inventory of institutional grade real estate. Global construction output is expected to almost double to US$15 trillion by 2025, up from US$8.7 trillion in 2012. Emerging markets in Asia will be the fastest growing region, but sub-Saharan Africa is expected to be the second highest.

Yet the philosophy of 'build it and they will come' won't prove universally successful. Some cities will grow and become creative hubs, generators of economic growth. Others will destroy wealth, with poor infrastructure, slums and rampant crime. Others still will be ghost towns. In some countries, the density of main cities will drive people away, to rural environments or satellite cities.

To read more about city expansion and other changes occurring in the real estate landscape, please refer to PwC's Real Estate 2020.

Asset management IPO activity?

During 2015, the macro-market initial public offering landscape slowed significantly given recent Chinese Yuan devaluation, historically low oil prices, slower global domestic product and increased focus on Fed monetary policy, with approximately 200 IPOs compared to approximately 300 in 2014. The financials/ real estate investment trust ("REIT") industries, including asset management sector, followed the overall marco-market easing, as the number of IPOs decreased by more than 50%. Additionally, increased pressure on IPO pricing saw valuations drop nearly 65% compared to 2014 according to PwC US Capital Markets Watch, ECM analytics, creating limited market opportunity for asset managers to go public.

For additional information, please refer to PwC' 6th edition of "US Asset and Wealth Management M&A Insights".

'Sustainability' transforms design of buildings and developments

Cities contribute an estimated 70% of the world's energy-related greenhouse gases while occupying just 2% of its land. Their locations – often in low-elevation coastal zones – and large populations make them particularly vulnerable to the impacts of climate change, such as rising sea levels. As the world rapidly urbanizes, so the pressures to make buildings more eco-efficient are mounting.

Quite how great this pressure becomes between now and 2020 depends on how sensitive the weather proves to be to climate change, and how fast energy prices rise. If extreme weather devastates a major city or destroys an annual food crop then pressure will mount, possibly with substantial new regulations. What's more, if energy price rises continue at the current rate, pressure will increase to improve buildings' energy efficiency, although exploitation of new energy sources could mitigate the pressure somewhat.

By 2020, it's likely that all buildings in advanced economies will need to have sustainability ratings. What's more, the concept of sustainability will have broadened to mean creating 'places' where people enjoy living and working. So, new developments will be designed with green spaces, good air quality, spaces for social gathering and so on.

PwC has included additional information about sustainability in the design of buildings and developments as well as other global megatrends which will impact the real estate market within its Real Estate 2020.

Growing in complicated times

Today's CEOs face a business environment that's becoming increasingly complicated to read and adapt to. Seven years on from the global financial crisis, the business landscape still hasn't really returned to what it was. Will it ever? Last year regulation, skills, national debt, geopolitical uncertainty and taxes topped CEOs' list of concerns about threats to business growth. None of these have gone away this year. In fact, the level of worry is higher today than at any point in the past five years. Concern about over-regulation in particular is still highest, cited by 79% of CEOs – making it the fourth year in a row that it's risen.

Geopolitical uncertainty, meanwhile, has become the second biggest concern, cited by 74% of business leaders. This comes at a time when terror attacks are increasing and touching every part of the world, many linked to the heightened conflict in Iraq and Syria. Global conflicts are also connected to anxieties about social instability and readiness to respond to crises, named by 65% and 61% of CEOs, respectively. Cyber security is also a worry for 61% of CEOs, representing as it does threats to both national and commercial interests.

Please refer to PwC's 19th annual Global CEO Survey which further discusses ways in which CEOs are leading and growing businesses in complicated times.

A housing option for everyone?

The percentage of US households owning a home declined from peak levels following the bursting of the housing bubble. The percentage of households choosing to own a home in the US has remained near historical low levels despite the economy and housing market showing signs of recovery. This has resulted in a rise in the number of rental households in the US. The interviewees for the 37th edition of Emerging Trends in Real Estate, 2016 have identified the potential opportunities that this growing and more diverse set of rental households could offer in the coming years.

Please refer to PwC's Spring 2016 US Real Estate Insights for additional discussion surrounding home ownership and rental trends in the US.

III. Update on tax matters

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Tax as a critical component in every finance transformation

Tax and Finance face similar challenges requiring a fundamental re-evaluation of operations and processes. Both need to better support their internal and external stakeholders—the business, regulators, and investors—often without access to increased resources. They must respond to demands for accelerated financial reporting/regulatory filing, greater predictive insight and decision support, and ongoing control, compliance, and risk management. And they must continually improve processes to eliminate waste and leverage technology to improve automation, data quality, and analytical capabilities.

Finance functions seek to meet these challenges by taking on 'transformation.' Transformation is not necessarily a single corporate event; more often, it consists of a series of strategic projects (large or small) that help to continuously improve and move along the maturity curve that executive leadership has defined for the organization.

What is critical for success? Transformation needs to be an integrated effort across Finance with Tax as a key participant. Tax must participate both to ensure its continued ability to meet its own global compliance obligations using high-quality data and also to help enhance the overall operational effectiveness of Finance. Transformation initiatives without Tax can conflict with basic Tax function requirements, with adverse consequences to the organization as a whole.

Please refer to PwC's Tax Function of the Future series to learn more about why many finance functions, large and small, are undertaking transformations and why tax needs to be an integral part of the process from the outset.

Key Tax issues for real estate investors

International tax regimes are diverse, complex and variant, and are usually full of fixed dates, terms and deadlines. These dates, terms and deadlines need to be observed carefully in order to avoid penalties and to receive certain tax reliefs or exemptions. At year end these obligations become even more difficult to understand and fulfil, particularly for real estate investors with investments in numerous countries.

Refer to the PwC Key Tax Issues for Real Estate Investors publication which is meant to give investors and fund managers an overview of important issues in real estate taxation in 34 tax systems worldwide. Further, the publication highlights what needs to be considered in international tax planning and the structuring of real estate investments and is further intended to help detect the need for specific action.

Transforming your business for a new global tax world

By 2020, how an asset management firm deals with tax risk will be viewed as a competitive advantage or disadvantage. Investors will expect robust and efficient tax infrastructure and will have minimal tolerance of tax uncertainty or tax adjustments. As a result, tax will be a key operational and business activity, requiring specialist resources, a new approach and integration into front, back and middle office activities. So what will be the drivers for this new global tax world? And how will investment firms transform to meet these challenges as the industry becomes an even more significant part of the financial services sector?

This publication will discuss why tax should not be considered solely as a risk to manage – it is also an opportunity. Managing tax risks and leakages well at all levels (investments, funds and investors) can distinguish asset managers from their peers. While managers have traditionally been tasked with generating performance 'alpha' for their investors, 'service alpha' in 2020 will be a key differentiator. The concept of service alpha implies an entirely new challenge for asset managers: how to communicate investors about tax matters. Service alpha will require the asset manager to first explain it and then help investors recognize its benefits.

Please refer to the PwC publication prepared as part of the Asset Management 2020 and beyond series which is meant to help asset manager's plan for the future.

Common tax considerations when utilizing U.S. Corporations to invest in U.S. real property

The competition for investor capital amongst asset managers has never been tighter. In an effort to remain competitive, many asset managers are implementing complex holding structures to facilitate varying investor preferences that are intended to optimize tax efficiency. Structures for investing in U.S. real estate commonly include real estate investment trusts, partnerships, non-U.S. entities and U.S. corporations.

While each holding structure noted above has its own advantages and challenges, US corporations, among other benefits, provide investors with an opaque structure which can eliminate several of the burdens associated with holding US real estate in a transparent structure, such as an investor level income tax liability and US income tax return filing requirement. Please refer to PwC's Spring 2016 US Real Estate Insights for a summary which is intended to provide a practical background of several of the most salient issues specific to U.S. corporations that asset managers and their investors often face.

IV. Technology trends

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Directors and IT: A user-friendly board guide for effective information technology oversight

Overseeing a company's information technology (IT) activities is a significant concern for boards of directors. The pace of change in this area is rapid, the subject matter is complicated, and the highly technical jargon used to describe emerging and evolving risks makes this a challenging area. And companies are relying more and more on technology to get ahead, often prompting substantial changes in how they operate. All of these factors can make the board's IT oversight responsibility appear harder than it is.

IT can certainly be a complex and intimidating subject to understand—from the benefits it can offer to the costly and disruptive risks it can present. Our research, which included surveying approximately 800 public company directors during 2012-2015, indicates many directors are confused by, and uncomfortable with, overseeing IT. They sometimes don't have an adequate understanding of the subject to be effective and confident in overseeing this area. And they do not necessarily have a well-well defined process to help them in fulfilling this very important responsibility. Together, these factors can create an "IT confidence gap".

What can the board do to bridge the "IT confidence gap?" The board should evaluate its process for IT oversight and ensure it is appropriate. While structured IT frameworks for IT professionals and management already exist, they are not designed for the board's role, which is oversight. PwC has prepared a Directors and IT guide, which includes the IT Oversight Framework specifically for the board's use. This guide should help directors determine how to best fulfill its IT oversight responsibility.

Cybersecurity update: financial services turnaround and transformation cybersecurity

As cyberattacks continue to escalate, forward-leaning financial services firms are beginning to leverage and link innovative cybersecurity tools, many of them cloud-enabled. These organizations are improving their security programs with technologies such as cloud-based cybersecurity services, Big Data analytics, and advanced authentication and biometrics.

Another measure of progress is a willingness to invest in cybersecurity. This year, average information security spending is up 14%. To learn more about the most significant cybersecurity challenges, please refer to PwC's Key findings from The Global State of Information Security Survey 2016.

Unlocking the power of data and analytics: Data is key to enhancing the value of the tax function

Technology-driven disruption, along with the ever increasing volume of data, is already having a major impact on companies and will continue to do so for the foreseeable future. A recent study estimated a 95% likelihood that jobs in the accounting and audit field will be computerized. In addition, computerization and the development of artificial intelligence and machine learning are being applied to solve tax challenges. The implications are that creating an environment where data can be leveraged for applied decision-making will become the norm and that the tax function is ready for transformation.

The tax function is one of the largest consumers of data within the organization, not only core trial balance data from financial systems, but also data from other transactional systems. Tax functions spend more than 50% of their time gathering tax data, while spending less than 20% of their time on strategic tax analysis, according to Tax Technology: Creating a strategic asset, a 2013 joint PwC manufacturers Alliance for Productivity and Innovation survey (MAPI survey). Many tax executives also report that obtaining tax-ready information is an impossible problem for them to address on their own because tax is just a downstream user of data.

PwC has prepared a publication as part of its Tax Functions of the Future series which discussed PwC's predictions around how streamlining the data collection and management process enables the tax function to, shift its focus from gathering data to analysis and strategic participation within the organization. Refer to Unlocking the power of data and analytics for additional reference of ways to redesign, redefine, and redeploy, tax to be strategic business asset.

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