

January/February 2008

# Real Estate Advisor

Looking lively:

**The life science  
real estate market  
perks up**

**EPA offers new tool for  
tracking water usage**

---

**How a cost segregation  
study can save you money**

---

**Credit crunch squeezes  
commercial real estate market**  
Adjusting to the new financing realities

---

**Ask the Advisor**  
Should I consider apartment properties?



**Marks Paneth  
& Shron** LLP

*Certified Public Accountants and Consultants*

622 Third Avenue  
New York, NY 10017

Telephone 212 503 8800  
Facsimile 212 370 3759

88 Froehlich Farm Blvd.  
Woodbury, NY 11797

Telephone 516 992 5900  
Facsimile 516 992 5800

Website [www.markspaneth.com](http://www.markspaneth.com)

Associated worldwide  
with JHI



# Looking lively: The life science real estate market perks up

The life science real estate market has come to life over the past several years. Sales of life-science-related facilities climbed to \$5.1 billion in 2006, compared with \$601 million in 2002, according to Real Capital Analytics, a national research and consulting firm focused on the commercial real estate investment market. Life science properties also are enjoying low vacancy rates and premium rental returns.

## REITS LIKE LAB SPACE

Up until the mid-1990s, life science real estate was considered a risky investment. The life science sector generally includes companies in the fields of biotechnology, pharmaceuticals, life systems technologies, food processing and biomedical devices. Such companies faced low profitability, high capital requirements and long product development cycles that sometimes ended in regulatory rejection.

## *Lenders are viewing life science real estate as a less risky venture.*

But as the industry has matured, life science real estate has come into its own as a relatively stable and profitable investment. In fact, several large real estate investment companies are increasingly competing for laboratory properties in prime life science clusters throughout the United States.

In mid-2007, for instance, real estate investment trust (REIT) Health Care Property Investors Inc. (HCPI) spent \$2.9 billion to buy an 83-building life science portfolio with properties in San Diego, San Francisco and Peoria, Ill. This makes life sciences the largest portion of the company's holdings, at 26%. HCPI previously concentrated its holdings in elderly housing, assisted living, nursing homes and medical office buildings. According to company executives, returns from the life science

portfolio will be 125 to 150 basis points higher than those from senior housing and 75 basis points higher than medical office buildings.

HCPI joins the ranks of San Diego-based BioMed Realty Trust Inc., which owns interests in some 8.6 million square feet of life science space, and Pasadena-based Alexandria Real Estate Equities Inc., with 11 million square feet of such space.

## ATTRACTIVE LIFE SCIENCE FACTORS

There are significant factors that have converged in recent years to make life science properties an attractive option for large and not-so-large real estate investors:

**Favorable demographics.** U.S. citizens not only are living longer, but the baby boomer generation is refusing to slow down as they age. That means the life science industry has a growing market for products that address health issues and prevention.

**Geographic cluster benefits.** Life science firms prefer to locate in established geographic clusters to gain access to the best scientific talent and resources. This gives investors and landlords the security of knowing tenants are committed to the area in which they have holdings. The most prevalent life science clusters are Boston, Los Angeles, New York, San Diego, San Francisco and Seattle.

**Long-term tenants.** Tenants also tend to make substantial financial commitments to the building they rent. They often bear much of the cost of build-outs, including creating clean rooms and lab space, and are thus less likely to move elsewhere.

**Low inventory.** The supply of life science facilities is low compared to nonspecialized office space, pushing up asset value and even prompting speculative development in cluster markets.

**Expanding life science companies.** Life science companies, such as Novartis, Genzyme and Biogen Indec Inc., are continuing to expand and absorb the lab space that is available.

**Lender acceptance.** Now that the industry is gaining ground in the U.S. and global economy, lenders are viewing life science real estate as a less risky venture. And the partnerships that life science businesses are forming with large pharmaceutical companies have inspired new credit support.

**Increased buyer competition.** REITs are stepping up competition to add life science properties to their portfolios, fueling interest in this niche.

### CAVEATS

Before investing in potential life science space, make sure it has the infrastructure to support the advanced climate control and information technology systems necessary to support work

with often-fragile living organisms. The facility should be large enough for labs and clean rooms, along with manufacturing and office space. That means the facility — which will probably house a number of life science firms — should be at least 50,000 square feet.

### AS ONE SLOWS DOWN, ANOTHER GEARS UP

Despite a slowdown in other real estate investment segments, the market for life science space seems destined to be as active as the baby-boomer generation it is gearing up to serve. So, this just might be the time to consider adding life science facilities to your investment mix — provided you do so in the right geographic location. 🏠

## EPA OFFERS NEW TOOL FOR TRACKING WATER USAGE

Commercial buildings use close to 20% of the drinking water in the United States, and it's the building owners who foot the bill for all those gallons of water. Moreover, they pay the energy bills to heat it and pump it.

Now, the Environmental Protection Agency (EPA) is offering a system that allows owners to track water usage and the subsequent bills in order to increase conservation and save money. It's a new feature in the EPA's online Portfolio Manager, which has been helping building owners nationwide track the energy efficiency of their facilities since 1999.

Introduced in June 2006, the water portion of the program doesn't yet have a rating system, but the energy portion does. Currently, the system helps building owners better understand their facilities' water consumption, as well as how it relates to energy use.

To begin tracking water, you must establish a free account in the EPA's Portfolio Manager ([www.energystar.gov](http://www.energystar.gov)). Then you need to set up an online meter for each water meter in your buildings, entering water usage data for each billing period. You can then track indoor water use, outdoor use, combined indoor/outdoor or wastewater. The system shows water use per square foot as well as cost per gallon per square foot, so comparisons can be made between buildings over time. Thus far, the EPA reports approximately 1,000 users with some 2,000 buildings.

Since the program is so new, the EPA Energy Star program, which oversees Portfolio Manager, doesn't yet provide water conservation resources beyond the tracking feature. But the EPA's WaterSense Program ([www.epa.gov/WaterSense/index.htm](http://www.epa.gov/WaterSense/index.htm)) offers helpful tips on water-saving products and services.

Although the tracking program hasn't yet established benchmarks to help building owners see how their water consumption efficiency and cost stack up with others, conserving water is clearly something commercial real estate experts recognize as a significant cost savings. Last July, as part of its 7-Point Challenge to members to become more green, the Building Owners and Managers Association International recommended owners track water and energy performance of their buildings using this very EPA tool.

# How a cost segregation study can save you money

When it comes to commercial buildings, not all depreciation is created equal. Under the traditional depreciation method, the purchase value is typically depreciated over a period of either 27.5 or 39 years. And the land on which the building sits isn't depreciable at all. But, you can shorten that depreciation period by having a cost segregation study performed.

## DEPRECIATING PARTS RATHER THAN THE WHOLE

A cost segregation study breaks down the components of a building into shorter-term depreciation categories. The idea is that some real estate components have a shorter lifespan than the shell and other major structural aspects of the building.

For these shorter-lived features — such as fixtures, carpeting, window treatments and site improvements — a depreciation schedule is set up over five-, seven- or 15-year timeframes. That means you can accelerate the tax-saving benefits of depreciating these property features. And, as most investors realize, a dollar saved in the first five years of a building's life is worth more than one saved a decade or two later.

Classifying shorter-term depreciable property components is complicated. It has been defined and redefined by a series of court rulings and changing

IRS rules. There are, in fact, six different methods identified by the IRS for providing a cost segregation analysis. You and your CPA can determine whether it's best to use one or a combination of methods in analyzing your properties.

## GETTING A QUALITY STUDY

Regardless of the methodology used, a cost segregation study and report should always:

1. Classify assets into property classes such as land, land improvements (parking lots, sidewalks, landscaping), building, and personal property (decorative fixtures, cabinets, security systems),
2. Explain the rationale (including legal citations) for classifying assets, and
3. Substantiate the cost basis of each asset and reconcile total allocated costs to total actual costs.

The preparation of cost segregation studies requires knowledge of both the construction process and the tax law governing property classifications for depreciation purposes. Knowledge of the applicable law and experience in cost estimating and allocation also are important.

## DISPELLING SOME MYTHS

Cost segregation studies aren't necessary for every property you own. You should consider one when you buy, build or remodel — or when you've done so within the last few years. The cost of the study is generally warranted only if the building or remodeling expenditures are substantial.

While cost segregation can result in tax savings, it's often a misunderstood tool. For example:

**It doesn't only defer federal taxes.** Cost segregation actually *reduces* federal income taxes by converting income that would have been taxed at the ordinary income rate (35% maximum) to income taxed at the capital gains rate (15% or 25% maximum). This is because, during the



ownership period, cost segregation generates additional depreciation, reducing the income taxed at 35%. Upon sale, the remaining undepreciated amount is taxed at the capital gains rate; however, the depreciation on some shorter-term depreciable personal property can be subject to recapture and taxed at ordinary income tax rates.

The owner of a building can retroactively use a cost segregation study to claim depreciation for prior years and generate net operating losses (NOLs), either carrying back the “catch up” of depreciation or carrying forward the NOLs to offset future income. There are, of course, benefits to be weighed when looking at how far the real estate is into its depreciable life.

**You don't need a multimillion-dollar property.**  
A building of any size can benefit from a cost

segregation study, but it's generally particularly helpful if the cost basis of the property is \$500,000 or higher.

**It won't increase your chance of being audited.**  
Actually, the IRS encourages a properly prepared cost segregation study because it generates more accurate accounting.

#### **DON'T TRY THIS ALONE**

Cost segregation studies can be complicated, and some items may be hard to classify. You'll also need to file an accounting method change request — if the study was prepared in the year after acquisition — to adjust depreciation to the shorter lives. In other words, don't attempt this study on your own. Be sure you work with a cost segregation expert. Your hard-earned money is at stake. 🏠

# Credit crunch squeezes commercial real estate market

## *Adjusting to the new financing realities*

In the wake of tighter credit requirements in the home mortgage market, commercial real estate borrowers are finding themselves in the midst of a credit crunch of their own. After enjoying the lowest rates in 40 years, commercial borrowers are facing more stringent underwriting requirements and the near extinction of interest-only deals.

The change in the commercial real estate lending climate hit suddenly last summer, leaving leveraged investors scrambling and the market in general competing in a more costly and cautious credit climate. According to real estate investment bank Buchanan Street Partners, commercial borrowers generally face reduced proceeds, stricter underwriting standards, less aggressive loan structures, and greater scrutiny of business plans and cash flow scenarios.

In other words, commercial borrowers face a new reality in financing fundamentals.



#### **NO MORE CHEAP DEBT**

As recently as early 2007, commercial investors could finance 85% to 90% of a property with a five- or 10-year, interest-only loan. Lenders, eager to compete aggressively for market share, were willing to underwrite deals with high

loan-to-value ratios in anticipation of rent increases and projected future income levels. And debt-service coverage ratios dipped as low as 1.0. Some lenders offered loans that didn't even meet that break-even point.

But all that changed in a matter of weeks as concerns about floundering home mortgages spilled over into the commercial realm. By late June 2007, fixed commercial mortgage rates rose an average of 50 to 75 basis points to approach 7%. Debt service climbed, as borrowers were required to pay principal plus interest. By July, the tighter market was blamed for scuttling some property acquisitions; investors simply couldn't get the leverage they needed to complete the deals.

Credit rating company Fitch Ratings warned in a July 2007 report that defaults on commercial mortgage-backed securities were likely to rise for the first time since 2003. The reason? The credit-rating company based its projection on the fact that overly aggressive lending conditions over the past two years let landlords and developers load up on interest-only loans and deals based on unrealistic rent increases. With rents lagging such expectations, increased defaults seem likely.

## COMMERCIAL SKY ISN'T FALLING

The commercial loan market isn't expected to experience the kind of pain the subprime segment has suffered. Rather, lenders are sizing up borrowers and their deals more cautiously. Lenders have returned to underwriting loans based on current — and not projected — cash flow from actual tenants.

What types of commercial real estate are most likely to get financing in this environment? Multifamily housing may be a safe haven (see "Ask the Advisor" on page 7), as well as some office properties in hot areas, such as Los Angeles or Seattle. Lenders may also open their pocketbooks for projects such as medical office facilities located close to hospitals. What they may not bite off on in today's market are land and non-necessary retail developments.

## TIME TO STRATEGIZE FOR THE FUTURE

The commercial mortgage credit crunch is expected to loosen as the year wears on. In the meantime, you can increase the value of your holdings through another real estate fundamental: Work with your financial advisor to develop a sound real estate strategy that includes property improvements, leasing, redevelopment, aggressive management and expense control. 🏠

## 5 THINGS YOU NEED TO KNOW

To cope with today's tighter credit market, commercial real estate investors and developers can expect lenders to:

- 1. Require additional equity for a real estate purchase or development.** The maximum leverage will likely be 70% to 75% of the purchase price, and possibly 80% if the property has a strong niche and considerable preleasing.
- 2. Offer extremely limited interest-only periods for permanent loans.** Also expect debt service coverage of 1.20 or better.
- 3. Scrutinize experience as a borrower, and as a landlord or developer.** A good track record is important.
- 4. Be unwilling to fund speculative projects based on projected rental numbers.** Line up preleasing agreements before seeking a mortgage.
- 5. Require a business plan with a clear exit plan.** In other words, how does the loan get repaid?

Finally, seek funding from on-book lenders — commercial banks, savings and loans, and life insurance companies — that plan to hold your loan on their balance sheet. Meeting requirements for financing that involves selling loans to investors in the secondary market is difficult in the current market, particularly for smaller or midsize investors.



# Ask the Advisor

*Should I consider apartment properties?*

The apartment investment market has been hot for some time now. In fact, one study co-sponsored by the Urban Land Institute chose apartments as the top sector to invest in for return potential in 2007. Both dire market conditions in the single-family housing realm and favorable overall demographics point to its continued strength as an investment segment.

## HOUSEHOLDS ON THE RISE

The biggest plus for this investment segment is that the United States is experiencing growth in the number of overall households that's expected to stretch to 2015 and beyond. And many of those households will be rentals.

*There's a limited supply of new apartments in the pipeline, despite growing demand.*

A 2007 report by the RREEF, a real estate service unit of Deutsche Bank, notes that the United States is projected to add 11.6 million new households between 2007 and 2015, an average of 1.5 million per year. That's 15% higher than the 1.3 million new households per year that were created between 2001 and 2006.

## ECHO BOOMERS ON THE MOVE

One component driving the apartment demand is the increase of the 20- to 24-year-old population. Another is a growing immigrant population. Both groups are strong participants in the apartment rental market.

Through the 1990s, the number of 20- to 24-year-olds shrank in the wake of the baby-boomer bulge. It started to grow again in 2001 thanks to the "echo boomers," children of the baby boomers. Echo boomers now account for some 30% of the U.S. population, or 76.3 million, RREEF notes. This age group is critically

important to the apartment market, because 75% of them historically are apartment renters.

Immigrants also increase rental rolls. Currently some 4 million immigrant households live in apartments and another 500,000 are expected to live in rental units by 2010, according to the National Multi Housing Council (NMHC).

Other age groups fueling the demand for multi-family housing are the 55 or older segment, which includes baby boomers who aren't ready for retirement housing, and the college student housing market, in which student housing needs are outstripping on-campus supplies as enrollments continue to climb.

## MARKET CONDITIONS ON THE WAY DOWN

Beyond population trends, current sagging real estate market conditions are also bolstering apartment demand because:

- ✓ Home ownership costs 30% more a month than renting, according to the NMHC,
- ✓ More stringent credit requirements are keeping renters from purchasing single-family homes,
- ✓ Mounting foreclosures on single-family homes push more people into apartment rentals, and
- ✓ A volatile single-family housing market and economic uncertainty prevent renters from making the jump to home ownership.

In addition, there's a limited supply of new apartments in the pipeline, despite growing demand.

## OPPORTUNITIES ON THE RISE

Face it: The gloomy single-family real estate market is likely to continue for some time. Your best investment opportunities may very well be in apartment complex projects. Talk with your financial advisor to see if they're a good fit for your portfolio. 🏠

# DEVELOPERS OF CUSTOM SOLUTIONS BUILT TO MEET YOUR NEEDS

*For nearly a century,  
Marks Paneth & Shron LLP (MP&S)  
has been a leader in providing answers to  
the complex tax and accounting issues  
that affect the real estate industry.*

*MP&S offers cutting-edge financial expertise you need  
to manage your assets and maximize performance.*



**Marks Paneth  
& Shron<sub>LLP</sub>**

*Certified Public Accountants  
and Consultants*

622 Third Avenue New York, NY 10017 • 88 Froehlich Farm Boulevard Woodbury, NY 11797 • [www.markspaneth.com](http://www.markspaneth.com)

*For more information, call 212.503.8846 or email: [contacts@markspaneth.com](mailto:contacts@markspaneth.com)*

## *MP&S Real Estate Group Partners*

*Arnold Gruber*

*Harry Moehring*

*Timothy Andrews*

*Robert Feldman*

*Stuart Becker*

*Steven Brass*

*William Jennings*

*Michael Siino*

*Robert Goldstein*

*Brad Eckstein*

*Arthur Cannata*

*Vincent Barra*

*Kurt Kiess*

*Howard Warshaw*

*Steven Schochet*

*Michael Saul*

*Steven Bergerson*

*Jay Kaplan*