News: National

November 12, 2008

Written by Randyl Drummer (rdrummer@costar.com)

How Will Commercial Real Estate Handle the 'Obama Effect'?

CRE Executives' Reactions Run the Gamut from Hopeful to Pessimistic. But the Industry Promises a Full Agenda For the Obama Administration and Democrat-Controlled Congress

Change is coming to Washington, DC, as promised -- and the commercial real estate industry is wasting no time in making sure its agenda is front and center for President-elect Barack Obama and the 111th Congress.

To almost no one's surprise, the CRE industry tended to favor Republican John McCain over Obama -- based at least in part on concerns that the Democrat's tax policies could adversely affect the industry's ability to continue attracting significant amounts of investment capital. An August survey of 425 real estate executives by law firm DLA Piper found that just over 30% believed Obama would have a more favorable impact on the industry as president, versus 67% for McCain.

With Obama now making the transition into office and the Democrats having strengthened their holds on Congress, CoStar Advisor polled real estate professionals on their thoughts regarding what should be the top priorities during the first 100 days of the Obama Administration. Suggestions include a laundry list of policy issues ranging from rejecting increases in capital gains and other investment taxes, to moving more aggressively to stabilize the Treasury and capital markets, suspending market rules regulating perceived asset value, investing in public construction and infrastructure and other economic stimulus, and reforming Fannie Mae and Freddie Mac.

Unlike the blizzard of legislation signed into law during the first 100 days of the Roosevelt Administration in 1933 and the Johnson Administration in 1964, Obama "must narrow his priorities to a precious few," said Dr. Paul C. Light, a professor at New York University, author and expert on presidential transitions.

"There will be no New Deal or Great Society next year. This may be the most difficult transition since Abraham Lincoln," Light said. "Roosevelt faced difficult decisions. But Obama is inheriting two wars, rising unemployment and a housing market and economy in turmoil. Obama can use some of these calamities to create a sense of urgency for mortgage relief and economic stimulus."

Jim Scofield, senior investment advisor for Sperry Van Ness in Raleigh, NC, did not vote for Obama because of his personal opposition to the president-elect's position on abortion. But the nation has no choice but to work collaboratively for the success of Obama and other elected leaders because "when they succeed, the American people succeed."

"We are obligated to establish policies that benefit all, and not ones that benefit just one constituency at the expense of others, like politicians do," Scofield said. "This works for everything, including commercial real estate where apartments, offices, stores, warehouses and factories are owned and used, directly or indirectly, by everyone -- rich or poor."

"The most critical issues for Obama's administration to address in the first 100 days are righting our economy and restoring confidence in the credit system, and concurrently establishing a health-care system where everyone can enjoy quality health care at a reasonable cost," Scofield said.

Industry Groups Mobilize

Meanwhile, organizations such as The Real Estate Roundtable are sharpening their message points well before the new Congress takes office Jan. 3 and Obama is inaugurated Jan. 20. Democrats hope to convene a lame-duck session of Congress next week to consider an economic stimulus package and a possible multi-billion dollar bailout for the auto industry. The Roundtable reached out to the Obama camp immediately after his election win last week, hoping to begin working with his transition team to address what it calls the "paralyzing shock of dysfunctional capital and credit markets."

"Our immediate and overriding concern lies with the credit and capital markets, which obviously are not working, particularly for commercial real estate," said Roundtable President and CEO Jeffrey DeBoer. "We face the twin challenges of frozen, and therefore inaccessible, credit markets and a growing economic recession with particularly adverse consequences for our sector and for overall job creation and growth."

The real estate industry's early planning and input on key political and presidential appointments will impact many issues important to real estate professional and their clients they serve, said Richard F. Gaylord, president of the National Association of Realtors (NAR), which represents primarily residential agents. The presidential transition team will shape how the housing and economic recovery unfolds, and the NAR has launched a "presidential appointments project" to encourage Realtors to seek seats on federal boards and commissions, and even executive branch appointments.

Real estate is well represented on Obama's transition team of economic advisers and within his Chicago inner circle. Valerie Jarrett, president and CEO of The Habitat Company, one of the Chicago area's largest private residential property management and development firms, co-chairs Obama's transition team and is said to be one of the president-elect's closest advisors. The firm has developed more than 25,000 housing units and currently manages more than 30,000 units. The lawyer and civic leader joined The Habitat Company in 1995 and has served as CEO since January 2007.

Obama's transition team of economic advisers also includes such banking and investment heavyweights as Warren Buffett, chairman and CEO of Berkshire Hathaway, and William Daley, chairman of the Midwest, JP Morgan Chase and former Commerce secretary under President Bill Clinton.

The transition team also includes Roger Ferguson, president and CEO of Teachers Insurance and Annuity Association/College Retirement Equities Fund (TIAA-CREF), and Penny Pritzker, CEO of Classic Residence by Hyatt. Ferguson is also former vice chairman of the Board of Governors of the Federal Reserve. Another Obama insider is Quintin E. Primo III, CEO of Chicago-based real estate investment and development firm Capri Capital.

Lingering Concerns Over Tax Policy
Commercial real estate professionals said the specter of higher taxes is among their chief concerns about the new president and a Democratically controlled Congress, especially an Obama campaign proposal to raise capital gains taxes on investments. The current 15% tax on capital gains is set to expire in 2010 and rise to 20%. Obama has proposed keeping that rate for single taxpayers making more than $200,000 a year and married couples earning more than $250,000, although he has also proposed eliminating the capital gains tax for startup and small businesses.

Another major issue for real estate investors is the tax treatment of so-called carried-interest compensation, a share of the profits of a successful partnership paid to the manager of a private equity or hedge fund.

The payments are designed as an incentive to the fund manager to maximize performance of the investment fund. Current law treats carried-interest compensation as a capital gain taxed at 15%. The Senate last year voted down a bill that would have taxed it as ordinary income -- as high as 39.6%. Obama has proposed a similar measure for the next Congress.

The Roundtable's DeBoer and its Chairman, Christopher Nassetta, CEO of Hilton Corp., urged Obama in a letter last week to reject any hike in the capital gains tax or amendment of the way carried-interest is taxed.

"The real estate industry needs a tax policy that does not provide unnecessary subsidies to fund 'uneconomic' development, nor does it believe that investment in real estate should be penalized compared with other investments," DeBoer said. "We need tax policy that reflects the economics of real estate. We need policies that facilitate troubled debt workouts, that help encourage investment in real estate and that do not unnecessarily discourage equity investment. Clearly, now is not the time to raise the capital gains tax."

Though certainly not the prevailing opinion, SVN's Scofield opined that Obama's pledge to increase taxes for wealthier Americans might actually be good for commercial real estate, historically viewed as a hedge against higher income taxes. "As long as the rules for depreciation and tax-deferred exchanges are preserved, higher income taxes may actually steer more investment dollars into commercial real estate and spur transaction volume," he added.

James Camp, legislative affairs chairman for the Southern California chapter of the National Association of Office and Industrial Properties (NAIOP), made a more conventional industry argument, that tax cuts will motivate investors on the sidelines to invest in business and real estate, while increases in the capital gains and other taxes "will accomplish the opposite."

"[Obama] has driven home the point that the wealthiest Americans are not paying their fair share. While that statement may be attractive to the family who is living paycheck to paycheck, the fact is that the so-called wealthy Americans are also the small- and mid-size business owners and entrepreneurs who ultimately employ millions of Americans in the companies that they own and operate," Camp said.

At this point, Camp doesn't see the new president and Congress bringing much upside to the commercial real estate industry.

"We foresee higher taxes, increased environmental regulation and higher construction costs. All real estate developers and investors are focused on reducing their debt in anticipation of the tougher economic times ahead."

Stimulating Development

Other Roundtable recommendations include strengthening the Treasury's stabilization plan by encouraging banks to extend loans, and to provide credit to job-producing projects that can begin development immediately.

Tax codes should changed to encourage foreign investment, and "mark to market" rules should be set aside in favor of a "mark to cash flow" model, the group advocates. Additionally, the government should set up a new credit facility for commercial real estate debt similar to the Federal Reserve's recently created facility for money market funds and commercial paper. Another idea is to model the credit facility after the Fannie Mae and Freddie Mac government-sponsored enterprises, or Europe's covered-bond structure.

The construction industry, meanwhile, is promoting infrastructure investment. Last week's unemployment report showed that the jobless rate in construction jumped to 10.8% in September, underscoring the need for Congress to act this month on stimulus bill spending for highway, bridge and other infrastructure, said Ken Simonson, chief economist for the Associated General Contractors. Obama and the new Congress next year should give high priority to renewing long-term highway, airport, water and wastewater funding bills, he added.

"This is a great time for both public agencies and private owners to go ahead with construction," Simonson said. "Many materials costs have tumbled since last summer and there are plenty of skilled contractors ready to bid for work."