2012 PRESIDENTIAL POLITICS
COMMERCIAL REAL ESTATE STRATEGY

Every year I spend much of the third and fourth quarters helping clients decide whether to continue holding or to sell assets that do not fit that client's long-term portfolio strategy. With the 2012 presidential election between Barack Obama and Mitt Romney looming ever closer, these decisions are particularly crucial. While the outcome of the election is unclear, one thing is extremely clear: things are going to change in January, regardless of who gets elected. With this in mind, we have a few critical weeks to decide if we want to sell this year or hold long term.

THE ENVIRONMENT PRE-ELECTION

January 1, 2013 is just 55 days from Election Day. Barring some action from Washington, the tax code will change significantly in the following ways that impact real estate investors:

- The tax reductions passed under the George W. Bush administration will expire.
  - Income tax rates will go up from a top bracket of 35 percent to a top bracket of 39.6 percent.
  - Long-term capital gains taxes will go from 15 percent to 20 percent.
  - Estate taxes will return to pre-Bush era rates – exceeding 50 percent with a very low exemption.
- The tax code changes contained in the Patient Protection and Affordable Care Act, also known as Obamacare, go into effect.
  - Wages of over $250,000 ($200,000 for single filers) will be subject to an additional 0.9 percent Medicare tax.
  - The Medicare 3.8 percent tax surcharge will go into effect on investment income for people with Modified Adjusted Gross Incomes of $250,000 or more ($200,000 for singles).

Given the short period of time between when the election occurs and when these tax changes automatically happen, some commercial real estate investors will choose to get ahead of the game and put their properties on the market so that the sale closes before December 31, 2012. In fact, some market analysts feel that this is already happening with the stock market. Furthermore, historical data shows that this has been the case in the past when capital gains rates were slated to go up. Should this occur again in the real estate market, a glut of available properties will likely slightly depress pricing, meaning that the last person to sell will end up getting fewer net proceeds. The worst possibility is for sellers to end up being contractually forced to close after January 1, locking in a low price and the potential for a high tax bill.

IF OBAMA WINS

If Barack Obama wins a second term and is able to execute on his plans, the following events will likely occur:

- The Bush tax cuts will be allowed to expire for higher income individuals.
- Capital gains taxes will adjust back to 20%.
- The new Obamacare taxes will remain.

Based on his stated goals, real estate owners can expect to face further tax increases over time. Given the administration's antipathy to traditional fossil-fuel based forms of energy, higher energy prices are also likely. This will increase operating expenses in commercial real estate properties. Whether they impact tenants through increased costs of occupancy or directly impact owners that pay the utility bills for the property this will, in either case, have a deleterious effect on net operating incomes. At the same time, the higher energy prices will also lead to increased inflation. Inflation will eventually lead to higher interest rates which lead to higher cap rates, further depressing the value of commercial real estate assets.

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IF ROMNEY WINS

If Mitt Romney wins, it is extremely likely that all of the Bush tax cuts will be extended and that he will delay the start of the Obamacare tax increases by executive order in advance of Congressional action. This will keep the capital gains and tax environment the same as it is now. On the longer term, though, the market is likely to see more changes.

During the campaign, Governor Romney indicated a desire for a 20 percent across the board tax cut. This, combined with additional pro-business policy is likely to spur significant economic growth. Growth should push commercial real estate NOIs higher, increasing property values. At the same time, though, it will also put upward pressure on interest rates to both keep up with a growing stock market and to prevent inflation. As is possible under a second Obama administration, upward cap rate adjustments are extremely likely in the middle-to-long term.

PRICE SENSITIVITY TO INTEREST RATES

One thing that is clear is that both potential presidents' policies will put upward pressure on interest rates. Given that there is a direct correlation between cash-on-cash returns and IRRs and interest rates, higher interest rates will force cap rates to move up to preserve investor returns.

The below table shows how much a property's value can theoretically shift with changing interest rates while providing the same return to the investor. It illustrates the impact of changing interest rates on the capitalization rate and the price of an investment real estate property bought with a $1,927,500 down payment and a 30-year loan, producing a 7.45 percent annual cash return after subtracting debt service from its $450,000 net operating income. Given the change in interest rates, the only way to maintain stable cash flow at a flat NOI is to reduce the loan balance, decreasing the annual debt service and the selling price.

Interest Rate	**4.75%**	**5.50%**	**6.25%**	**7.00%**	**7.75%**	**8.50%**
Cap Rate	**6.60%**	**7.00%**	**7.41%**	**7.80%**	**8.19%**	**8.57%**
Price	**$ 6,822,821**	**$ 6,425,000**	**$ 6,074,909**	**$ 5,765,801**	**$ 5,491,972**	**$ 5,248,590**
Loan Amount	(4,895,321)	(4,497,500)	(4,147,409)	(3,838,301)	(3,564,472)	(3,321,090)
Down Payment	*1,927,500*	*1,927,500*	*1,927,500*	*1,927,500*	*1,927,500*	*1,927,500*
NOI	450,000	450,000	450,000	450,000	450,000	450,000
Debt Service	(306,436)	(306,436)	(306,436)	(306,436)	(306,436)	(306,436)
Net Cash Flow	*143,564*	*143,564*	*143,564*	*143,564*	*143,564*	*143,564*

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In the real world, though, there is not a direct one-to-one correlation between interest rates and cap rates. Furthermore, the correlation varies from product type to product type. While single-tenant net-leased investments are extremely interest rate sensitive since investors buy them largely for their net cash flow, Class B and A-office buildings will adjust less if interest goes up due to economic growth since they should be able to significantly grow NOI as their tenants' prospects improve. The correlation also weakens when interest rates increase significantly since the property's intrinsic value typically sets a floor below which its value will not drop.

WHAT I WANT TO DO

I want to immediately sit down with owners that are making Sell vs. Hold vs. Buy decisions for the short and middle term. We have a few critical weeks to decide if it makes sense to sell in 2012 vs. hold long term. The decision should focus on analyzing both the state of presidential politics and the likely changes to both the tax code and to the country's economic outlook. This is especially important for owners that are considering an exit from commercial real estate, **as the current environment is an especially favorable one for those who will have capital gains and recapture tax liability.**

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