Cybersecurity: A Business Threat for Contractors

By Christopher Mellen and Ian Shapiro

Recent strides in the construction industry to automate processes—such as accounting, project management and Building Information Modeling (BIM) software—introduces a corresponding set of new cyber risks. Contractors are vulnerable to the same cyber threats that impact any industry—including phishing scams, ransomware attacks and distributed denial of service, to name a few. While larger construction firms have taken measures to increase cybersecurity, many small to mid-sized companies aren't fully aware of what threats they could face, or how to start hedging against them.

Compared to the financial services and healthcare industries, construction companies may not seem like a prime target for hackers, but documented cyber attacks have proven otherwise. Nine construction companies reported experiencing cyber attacks in 2015, an increase from just three incidents the prior year, according to the 2016 Verizon Data Breach Investigations Report.

In addition to proprietary employee data, other potentially vulnerable information includes sensitive client data, tenant personally identifiable information (PII) and non-public material information. Construction firms also house computer-aided design (CAD) drawings and blueprints to sensitive buildings, which hackers can exploit to inflict physical damage. From a national security perspective, firms involved in the construction of sensitive government facilities, critical infrastructure or even facilities for emergency management, public health or medical providers, could also be vulnerable to a cyberattack that might jeopardize those services.

Cybersecurity vulnerabilities in the construction industry are compounded by the growth of cloud computing and the Internet of Things (IoT). For example, as contractors move management and accounting software to the cloud, employees can access those systems on their personal devices. A breach occurring at the personal level, without the proper cybersecurity, could have severe implications for the larger cloud-based ecosystem. The same principle applies for the growing demand for smart devices, such as heating and cooling systems. With increased connectivity, the security and/or vulnerability of each individual device factors into the whole system's integrity.

Cyber under-investment and negligence can cause real financial harm to construction companies. Here are the

two key ways lax cybersecurity could turn into a business problem before a breach takes place.

1. The Company Can't Survive an Initial Cyber Vetting.

New York's Department of Financial Services (NYDFS) recently issued the "first-in-the-nation" cybersecurity regulation. Under this guidance, financial institutions are required to implement written third-party cyber risk policies and confirm strong due diligence practices are used to evaluate the adequacy of third parties' cyber practices. Contractors are increasingly asked to demonstrate sound cybersecurity practices, whether under a law such as the NYDFS cybersecurity regulations or as an emerging best practice. In addition, the standardization of third-party cyber risk assessments makes it easier than ever for companies to vet third-party vendors and contractors. Construction companies that either lack these internal controls or are unable to effectively communicate them may be unable to survive many request for proposal (RFP) processes—or may even be ineligible to participate or prequalify for a project owner.

2. Your Competitors Offer More Security.

All other things being equal and given the financial and reputational fallout from a cyber incident, clients will opt to entrust their data to contractors with strong, documented cybersecurity practices. To protect their own reputations, decision makers within the client's enterprise are likely to place a high priority on this issue, making cybersecurity an important differentiator in the marketplace.

Companies of all sizes are at risk. In 2015, 43 percent of cyberattacks were against small businesses with less than 250 employees, according to data from Symantec. The reputational and fiscal damage resulting from a cyberattack is far more impactful for small businesses. In fact, a Cyber Security Alliance study found that 60 percent of small businesses that experience a substantial cyberattack are permanently put out of business within a six-month period. Cybercriminals may specifically target mid-sized and smaller construction companies, which may not have prioritized cybersecurity like their larger counterparts. Further, it may pose a risk to large general contractors who rely heavily on smaller subcontractors, who may not have properly assessed their cybersecurity.

As the construction industry ventures into the technological realm, companies can't afford to ignore cybersecurity. The first step to strengthening cybersecurity is conducting a risk assessment to understand a company's vulnerabilities and business risks. Once contractors have a baseline understanding of their cybersecurity needs, they can shore up their policies. Being able to demonstrate a commitment to strong cybersecurity practices is becoming a key issue for today's contractors, even if they've never experienced a data breach.

REIT IPO Watch: 2017 Progress Report

By Brent Horak

After IPO activity slowed to a trickle in 2016, the capital markets community projects a more positive forecast for IPOs across industries in 2017. Two-thirds (67 percent) of capital markets executives at leading investment banks predict an increase this year in IPOs on U.S. exchanges, BDO's 2017 IPO Outlook study found, with 19 percent predicting a "substantial" uptick.

For the real estate industry, the IPO market may be marching ahead at a more measured clip, continuing to face many of the same hurdles that contributed to the recent downward trend in REIT IPOs, from nine in 2013 to four in 2016. BDO found executives' predictions for real estate IPO activity fell in the middle of the pack among industries, with 37 percent expecting IPO activity to increase in the sector and 31 percent expecting activity to remain flat in 2017.

Publicly traded REITs posted positive returns of about 8 percent in 2016. Although the asset class underperformed the broader S&P Index for the year, NAREIT predicts a stronger 2017 for REITs and commercial real estate, driven by continued economic momentum and increased demand. Nonetheless, the sector will also grapple with big questions—most importantly, the possibility of a downturn as the current real estate cycle progresses. National Real Estate Investor notes REIT IPO activity this year could vary significantly across sectors and property types. Some REIT sectors are currently trading at a premium to their net asset values, so IPOs could be concentrated by sector this year. Of course, the decision to go public will ultimately be influenced by how the share price stacks up to the REIT's net asset value.

Let's take a look at REIT IPO activity so far this year and the factors that will impact how the rest of the year unfolds.

In January, Invitation Homes raised $1.54 billion in its offering, the largest U.S. IPO since October 2015 and the largest REIT IPO since November 2014. The company issued 77 million shares at $20.00. As of mid-March, the shares were trading at $21.40. Private equity group Blackstone purchased Invitation Homes in 2012 and spent approximately $10 billion to build Invitation's portfolio of 48,000 homes, CNBC reported. Invitation's homes are now 96 percent occupied and draw an average monthly rent of $1,623.00, according to Forbes.

Though this IPO comes after other recent bets on rental homes, including the merger of Starwood Capital and Colony Capital to form Colony Starwood Homes in January 2016, the window for IPO activity in the single-family home sector may be closing. Housing prices have rebounded significantly since the recession, but remain slightly below their pre-recession peak. Currently, there are 11 private single-family home rental businesses that own more than 1,000 homes each. Performance in the single-family REIT sector was strong in 2016 with 26 percent returns. But as the housing market steadies, portfolios are no longer available at "bargain prices," so selling to a peer may generate better exit opportunity than an IPO for those businesses moving forward, Forbes predicts.

Other REIT IPO activity so far includes Connecticut-based Mortgage REIT Sachem Capital and New York City-based Clipper Realty. Sachem Capital opened for trading this year on February 10 at $4.90 for its offering of 2.6 million shares. Shares are trading at $5.00 as of mid-March. Clipper Realty also debuted on February 10, offering 5.6 million shares priced at $13.50 per share. The shares have hovered around that price, increasing less than 1 percent.

With economic uncertainty ahead as legislative and regulatory policy play out under the new administration, it is difficult to know how the capital markets and IPO activity may be impacted. The real estate industry's recovery is entering its ninth year, and all eyes will be on key measures such as vacancy rates and rent growth. Focusing on these measures alone, however, overlooks the strong sector fundamentals set to support growth for commercial real estate this year, NAREIT asserts. Notably, demand for leased space is outpacing supply despite an uptick in construction in recent years.

Healthcare, industrial, net lease and manufactured homes portfolios are performing particularly well in the current market as most REITs in those sectors are trading at premiums to their net asset value, according to National Real Estate Investor. Those types of portfolios may be particularly ripe for IPO activity this year. Last year was a challenging IPO environment with many companies electing to forgo a public offering. But if the cadence of REIT IPOs in Q1 is any indication, that sentiment is changing fast.

Effects of Potential Tax Reform on the Real Estate Industry

By Sean Brennan

Now that the dust of a contentious presidential election cycle is settling, tax reform may be more likely in 2017 than in past years. There are currently two plans we can look to for guidance on reform: President Donald Trump's revised plan and the House GOP plan. Both contain significant reductions in individual and corporate tax rates, limitations on deductions and simplification of administration of the tax system. While the plans are summaries of proposed tax reform and give us a basic understanding of their intentions, neither plan answers all our questions concerning implementation for taxpayers.

Provisions of each proposal may affect the real estate industry in the long term, including the current write-off of acquired property, limitations on the deductibility of interest expense and the overall reduction of tax rates.

Tax Rate Reduction

Arguably the most important potential tax reform for both individuals and corporations is tax rate reduction. The president's and the House GOP tax reform plans both call for significant tax rate reduction for both individuals and corporations. The two plans call for reduced corporate tax rates of 15 percent and 20 percent, respectively. Under the president's plan, business income earned by pass-through entities would also be taxed at a 15 percent rate. Under the House GOP plan, income from pass-through entities would be taxed at a maximum rate of 25 percent. It's not clear whether income from rental real estate would qualify as "business income" under the president's plan. Both plans call for a repeal of the corporate alternative minimum tax (AMT).

To reduce business tax rates, the president's plan calls for the elimination of most business deductions and credits, except the federal R&D credit. The House GOP plan also calls for reducing business deductions, including the deduction for interest expense in excess of interest income. However, there is a proposal under the House GOP plan to allow immediate write-off of investment of both tangible and intangible assets, including property.

Carried Interest

The president's plan proposes altering the tax treatment of carried interest. Carried interests are commonly used when forming a real estate development partnership to compensate a promoter for services rendered to the partnership with an interest in the partnership. Ultimately, the promoter can be taxed using favorable capital gains tax rates. If carried interest taxation rules are changed, promoters may be required to pay taxes on receipt of carried interests using ordinary tax rates.

Property Depreciation

The last rewrite of the Internal Revenue Code (IRC) in 1986 extended depreciable lives for commercial real estate from 19 years to 31 years. Depreciable lives now are set at 39 years for most properties acquired in 2017.

As mentioned above, the House GOP plan includes immediate expensing of all acquisitions of tangible and intangible property. Therefore, commercial buildings and other real estate development would be fully written off in the year acquired or placed in service. A similar provision is included in the president's revised plan, which proposes full expensing of plant and equipment for manufacturers. But the plans also call for the elimination of deductions for net interest expense on debt. Thus, interest expense deductions would be disallowed to the extent they exceed the taxpayer's interest income. Taxpayers would have to weigh the benefits of the simplification of an immediate write-off of newly acquired property against the loss of tax deductions for interest on the debt used to acquire the asset. Net operating losses resulting from the immediate expensing of commercial real estate would be able to be carried forward indefinitely, with no carryback allowed.

Mortgage Interest Deduction

Currently, mortgage interest payments for acquisition debt up to $1 million and $100,000 in home equity debt are deductible. The president's plan calls for limitations or phaseouts of itemized deductions at $100,000 for single filers and $200,000 for married filers. The House GOP plan calls for the elimination of nearly all deductions except the mortgage interest deduction and charitable contribution deduction.

Alternative Minimum Tax/Net Investment Income Tax

Under both the president's plan and the House GOP plan, AMT and the net investment income tax (3.8 percent on net investment income) would be repealed.

Looking Ahead: We'll Be Watching

While it is very early in the process of rewriting the IRC, the prospects of reform continue to grow stronger with a Republican White House and Republican control of the House and Senate. Real estate companies can review potential reforms now to prepare for scenarios that could be ahead. We will continue to monitor these preliminary tax reform plans, as well as others that may arise, in the coming months as the process unfolds.

Did You Know...

According to an Associated General Contractors of America survey, 73 percent of construction companies surveyed plan to hire new employees in 2017.

In the fourth quarter of 2016, home price gains accelerated in 89 percent of U.S. metropolitan areas, according to the National Association of Realtors.

Overall construction spending in 2016 was 4.5 percent higher than the prior year, according to the Commerce Department.

The data center and specialty REIT sectors outperformed the S&P Index's 1.9 percent total return rate in January 2017, delivering returns of 8.05 percent and 9.42 percent respectively.

Total construction employment in January increased 2.6 percent from January 2016, or approximately 170,000 jobs year over year, the Associated General Contractors of America reported.

Cross-border transactions in the real estate industry accounted for $65.5 billion in sales—a decline of one-third from 2015 levels, but up from just $43.1 billion in 2014, according to Real Capital Analytics.

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