
Meet the New Neighbors

Tenant-in-Common Investors Move into the Multifamily Market.

Source: MULTIFAMILY EXECUTIVE MAGAZINE

Publication date: 2005-06-15

By John Caulfield

For SCI Real Estate Investments of Los Angeles, there have been two earthshaking events in its business. The first, which happened more than a decade ago, resulted in the firm's founding: SCI started out acquiring and reselling distressed properties after a devastating earthquake shook Southern California in 1994.

The "second earthquake," according to [Adam Bryan](#), SCI's vice president of sales and marketing, came in 2002. That year, the Internal Revenue Service issued a ruling that clarified how property owners could defer capital gains taxes on relinquished real estate by parking their cash into other properties through co-ownership agreements.

These arrangements are known as tenant-in-common, or TIC, structures. They've become a specialty for SCI, which concentrates on acquiring income-producing properties and selling them to individual property owners who invest proceeds from real estate sales to acquire fractional ownership interests in larger and usually newer and higher-quality properties such as industrial sites, shopping malls, office buildings, or garden apartments.

That IRS ruling triggered an explosion in tenant-in-common activity. SCI, which now works with a network of 350 investors, expects its portfolio to increase to \$1 billion this year, from \$700 million in 2004.

Bryan says his company is benefiting from a TIC market that he predicts will stay "strong and healthy," partly because housing prices are making rental properties more attractive to buyers, but also because investors today have different goals than those who got into real estate during past boom-and-bust periods. "You have different tax structures and different [investor] motivations. TIC investors are looking more for wealth preservation than wealth accumulation."

As anyone following the industry knows, TICs have emerged as the real estate market's latest rivulet of investment capital. Equity raised through securitized TICs is expected to exceed \$4 billion in 2005, from \$166.7 million in 2001, according to Deloitte & Touche and San Francisco-based Omni Brokerage, which specializes in qualifying properties for TIC investments.

And those calculations don't include what's being raised by companies like SCI that sponsor properties as real estate rather than securities (see "Exit Options," p. 68), which could hike the total to around \$7 billion, according to estimates from the Sacramento, Calif.-based Tenant-in-Common Association.

"For years, I've been wrong about the growth of 1031s and TICs, which seem to double every year," says Adam

Handler, who leads PriceWaterhouse Coopers' like-kind exchange group.

Doing the Numbers

The U.S. Tax Code, specifically Section 1031, which lets property owners defer capital gains taxes when they exchange "like-kind" properties for investment purposes, is the foundation upon which TICs are expanding. For example, SCI's portfolio includes Deer Valley Village, an 842-unit apartment complex in Phoenix that it purchased from multifamily owner and manager Archstone-Smith last September for \$71 million with tenant-in-common money.

Such transactions, generally structured as 1031 exchanges, account for between 2 percent and 5 percent of all 1031 transactions. But some TIC sponsors are already predicting that these deals could someday represent one-quarter of that total. "We're seeing a substantial change in the investment community, like how mutual funds altered the way people bought stock," observes Cary Losson, president of 1031 Exchange Options, a registered rep based in Walnut Creek, Calif., that specializes in putting investors into tenant-in-common 1031 exchanges.

Losson believes these structures could also work for larger institutional investors and property owners who are searching for "a reliable chain of disposing properties at fair market value," he says. "You can build a nice exit [strategy] business model with TICs."

Investors are certainly interested in the concept. Losson's firm expects to place \$1 billion in real estate this year with its 500 to 600 investors. And sponsors are gearing up for better days ahead. SCI's acquisition team has grown to 12 people from three during the last few years. U.S. Advisors, a Napa, Calif.-based company that is the industry's largest multi-family sponsor with 13,000 apartment units in 1031 structures, last year assembled a five-person sales team. This year, it expects to raise between \$350 million and \$400 million in equity for investment in tenant-in-common deals, \$250 million to \$300 million of which would be for multifamily, according to Kevin Fitzgerald, U.S. Advisors' president.

Multifamily Issues

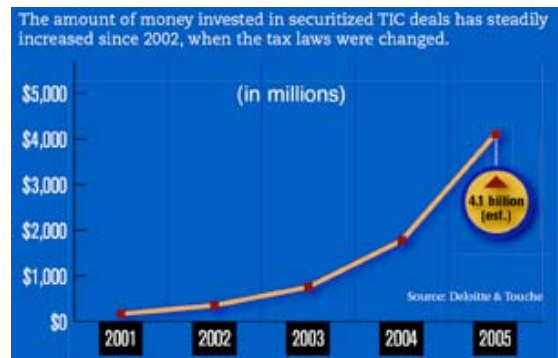
Some big players, though, wonder how much of this money will end up in multifamily properties. Currently, apartments account for about one-fifth of all TIC deals, a figure that isn't expected to go much higher.

"I don't see TICs becoming a real big factor [in multifamily], because the yields on apartments, on a cash-on-cash basis, aren't as good as other properties," says David Schwartz, managing member with Chicago-based Waterton Associates, which owns and manages 15,000 apartment units. "We entered into discussions with one TIC fund, but they walked away because they couldn't make the yields work."

David Cardwell, vice president of capital markets and technology for the National Multi Housing Council, said lenders he's spoken with are ambivalent about financing TICs. They question the leverage, which tends to be 50 to 60 percent of the acquisition price, and no one knows yet how complicated a tenant-in-common deal would be to unravel if an investor declared bankruptcy or a property went into foreclosure.

There is a fear in some quarters that TIC syndicates, which can include up to 35 investors, could start looking too much like limited partnerships, whose excesses in the 1980s gave real estate investment a black eye. Skeptics raise red flags about the sheer number of players pouring into this field. In 2002, there were eight securitized tenant-in-common sponsors; by the end of this year, there could be 65. They also wonder about tenant-in-common investors' knowledge about real estate, managing a property, or how shifts in market conditions can render profit projections irrelevant.

"TICs will last as long as interest rates stay low, and as long as investors understand what they are buying," predicts



TIC-ing Upward

Mike Kelly, vice president of acquisitions at United Dominion Realty Trust, which owns and manages more than 80,000 apartments around the country.

Several sources note that TICs have very little liquidity. "It's like owning a bond," observed Ned Midgley, vice president with CB Richard Ellis' investment property group. There isn't much of a secondary market, either, so investors have few options if they want to exit a TIC before the building is resold.

The Four Ts

While there is some regulatory wrangling over TICs (see "TIC-ing Upward" below), it hasn't tempered the optimism expressed by sponsors and some analysts about TICs' growth potential. Even Kelly acknowledges that the tenant-in-common sponsors he knows are having no trouble finding investors, many of whom are people near retirement who want steady cash flow, respectable returns, and a property in which their management involvement is strictly passive. "There is a good percentage of real estate owned by non-institutional investors who want to get away from the three 'Ts'—toilets, trash, and tenants—and go into the fourth 'T': travel," says Mike Franklin, executive vice president with FORT Properties, a tenant-in-common sponsor based in Los Angeles.

And apartments remain a relatively appealing option. Total return for TIC properties still outpaces most other investment alternatives, according to Hessam Nadji, Marcus & Millichap's managing director of research services, who points out that rental properties look even more appealing given skyrocketing home prices and the influx of immigrants, many of whom will be renters initially.

Finally, cap rates in 2004 averaged 6.9 percent on apartments sold to TIC deals, versus 8 percent for offices, 8.1 percent for retail properties and 8.7 percent for industrial buildings, according to Real Capital Analytics, a New York-based research firm.

For Norm Benson, the five TIC-structured deals he's been part of over the past several years have been matters of simple arithmetic: the tax deferrals saved him money. Benson, a 72-year-old property owner and manager living in Signal Hill, Calif., recently sold an 18-unit apartment building in Long Beach, Calif., for \$1.2 million, and moved his proceeds into fractional ownerships of four buildings, including two Phoenix-area apartment complexes, priced at \$38 million and \$40.5 million respectively, that were sponsored by Irvine, Calif.-based Passco Real Estate Enterprises. "It's a gamble, like anything else," admits Benson, who makes a point of visiting each property he invests in. TIC structures have allowed Benson to get into buildings he couldn't have touched as a sole owner. He takes comfort in the fact that Passco's founder, Bill Passo, is credited with practically creating the TIC market in the 1990s. And Benson still thinks real estate is a better bet than the stock market, which he calls "a losing proposition."

Market Matters

But these structures aren't just putting their money into buildings in the highest-growth markets. As TICs (once a West Coast phenomenon) move north, sponsors seem more willing than other investment groups to consider secondary markets such as Rochester, N.Y., according to Dan Fasulo, a senior associate with Real Capital Analytics.

Others have observed the same thing. "REITs and pension funds are exiting secondary markets at a time when TICs are trying to achieve yield and will go where they think they can get cash flow," says Keith Harris, executive vice president of capital markets for The Laramar Group, an owner and manager based in Chicago.

That doesn't mean, however, that investors are settling on secondary properties; in fact, the opposite seems to be the case. Passco favors Class A buildings with a minimum of 200 units, according to William Linn, the company's president. U.S. Advisors' Fitzgerald avoids investing in properties built before 2001 to minimize renovation costs prior to a building's disposition. And SCI seeks properties in markets "that are starting to turn the corner," says Scott Derrick, its vice president and director of acquisitions.

The growing popularity of this financial structure has raised questions about its impact on the market and property pricing. For their part, sponsors reject suggestions that the influx of TIC money is inflating prices. Tom Jenke, SCI's vice president of marketing, notes that any impact TIC activity might have on prices would pale beside last year's decision by pension funds to double their investment in real estate to \$40 billion.

Some industry observers, however, think TICs and their sponsors have become hypnotized by the ever-rising prices and are downplaying, at their own peril, variables that could erode their return and reduce the properties' resale prospects. "People are doing the analytics to see how far they can push down the yields, without taking into account the value of the property itself," says Kevin Shields, president of Los Angeles-based broker dealer Griffin Capital, which has yet to find a multifamily property that's priced to its liking.

The "what ifs" abound: Are tenant-in-common sponsors putting aside sufficient reserves from equity raised to cover revenue or dividend shortfalls from the property? Have they factored into their return equations the market fluctuations that could tamp down rents or cause interest rates to rise or vacancy rates to drop?

These caveats aren't lost on the tenant-in-common sponsors or reps, who emphasize the credibility and conservatism of their research and their reputations to dispel doubts about whether the exchanges they advance are financially sound and legally bulletproof. 1031 Exchange Options touts its relationship with qualified intermediaries, third-party entities through which exchange money flows that wield considerable influence over investors' choices. U.S. Advisors maintains a partnership with CB Richard Ellis, which handles due diligence on properties it wants to buy.

"We're making sure our deals aren't overloaded in a way that could be construed as abusive," says Mike Preston, chief operating officer for the Houston-based sponsor Creekstone Partners, "because the general consensus is that this isn't going to last forever."

-John Caulfield is a freelance writer in Old Bridge, N.J.

Exit Options

Tenant-in-common deals may be an increasingly popular investment option, but investors who want to get out of the deal early face some challenges: TICs aren't very liquid investments.

So far, the most common option for investors looking to cash out before the property is resold has been to sell his or her ownership stake to the other investors in that particular TIC structure, although it remains to be seen how marketable that stake would be if the property's value began to decline. Another strategy that's gaining acceptance as a solution to this problem is an "up-REIT transaction, where investors convert the TIC into REIT shares that can be parceled off, says Mike Preston, chief operating officer for Creekstone Partners, a TIC sponsor.

Part of the challenge with exit strategies comes from the fact that questions persist as to whether SEC-regulated tenant-in-common 1031 exchanges themselves are securities, real estate, or both. The grey areas relate to qualifications and licenses to sell either, which differ markedly. This confusion has prompted investigations by the National Association of Securities Dealers into the industry's selling practices.

Some tenant-in-common sponsors believe pro-real estate competitors are in violation of the law. But if TIC 1031s aren't real estate, "why is a deed issued?" asks Al Mansell, president of National Association of Realtors. The Washington-based group isn't opposed to securitizing tenant-in-common deals, Mansell says, but it does want the SEC to allow realtors to act as sponsors in these exchanges.

