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TIC Industry Reaches A Turning Point

The tenant-in-common industry undergoes major changes as it comes into its own.

Lara Fuller

The tenant-in-common (TIC) sector was once a relatively small part of the overall real estate industry. TIC transactions first became popular on the West Coast in the early 1990s, attracting a limited number of investors and lenders. However, as the industry matured, it quickly gained attention across the country. "It was initially a West Coast phenomenon," says Clay Womack, chief executive officer of Direct Capital Securities in Santa Monica, California. "It has now migrated out to the heartland and is becoming a universally accepted exchange investment of choice, not just convenience."



A TIC sponsored by SCI Real Estate Investments recently acquired the Kroger-anchored Woodmont Village in Atlanta.

"The tenant-in-common industry has matured significantly in recent years from its birth in 1994," says Bill Winn, president of Passco Companies in Irvine, California. "TICs have enjoyed a rapid rise to fame. Transaction volume grew approximately 100 percent per year between 2002 and 2005. Since 2006 that growth has continued, albeit at a slower rate."

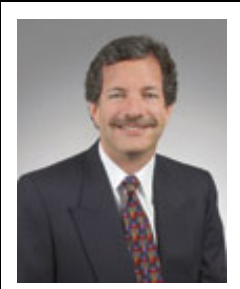
Adam Bryan, senior vice president and director of corporate sales of SCI Real Estate Investments in Los Angeles, has also seen a significant increase in the number of TIC transactions in recent years. "The TIC industry has changed dramatically over the past few years as demand has risen steadily for TIC product," he says. "More and more TIC sponsors have entered the market creating more competition, and TIC offerings have become more commonplace and accepted by investors and real estate brokers."

Now, the TIC industry has actually become so popular that it has become saturated in some marketplaces. Many of the people that jumped in without much forethought are now facing difficulties. "The field has become very crowded over the past several years," says Marc Goldstein, president of Covington Realty Partners in Chicago. "Many different people in the real estate industry looked at the TIC business as a 'gold rush' and we are now seeing an erosion of sponsors. Most people entered the business without the proper funding, business model or expertise. They are now having their hat handed to them; they do not have the ability to hold a property until the equity sells, deal with investors or report in a professional manner. This is leading to their leaving the marketplace or being pushed out."

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"Whenever there is a lot of excitement about an industry, there are always people who jump on board, but they're not fully committed to the industry," says David Waal, principal with Presidio Exchange Advisors in Walnut Creek, California. "This is the environment we are in today. There will be many changes in the sponsors who got into the industry then realized that it's not for them and also for the reps who are selling TICs. It takes a full-time commitment by sponsors and reps and too many people on both ends have tried doing it part time."



David Waal, principal with Presidio Exchange Advisors.

However, though the TIC industry is somewhat tumultuous at the moment, in the end, these changes will most likely help strengthen the industry. "The stabilization of the industry has led to some sponsors pulling out," says Winn. "Sponsors need to have the ability to close escrow with their own funds prior to raising equity from TIC investors, a difficult task for the newer and undercapitalized firms. This 'weeding out' is good for the industry as the stronger firms are better able to afford the infrastructure need to manage the real estate and investor relations over the long term."

The reason that so many people have gravitated toward TIC transactions in the first place is because of the multiple benefits it offers, most of which are not found in other real estate sectors. "The key elements enhancing the industry's attractiveness are centralized management, consistency of returns, the ability to own institutional grade property as an individual, ease of investment and strength of sponsors," says Womack.



Clay Womack, chief executive officer of Direct Capital Securities.

The major benefit of the structure is the ability for investors to have ownership of a property without all of the work that usually comes along with that. "The attractiveness of a TIC and its structure is that it's an exit strategy for real estate investors," says Waal. "They can still be invested in real estate without the hassles of day-to-day management."

Many commercial-grade investment properties would be out of reach for a single, private investor. However, in a TIC, an investor is able to take ownership of a higher quality property than they would on their own. "The tenant-in-common/1031 tax-deferred exchange investment vehicle has placed institutional quality real estate within reach of thousands of private investors, while helping them to successfully defer their long-term capital gains," says Winn. "For example, an investor can sell their management-intensive and self-managed investment properties for an undivided tenant-in-common ownership interest of an institutional quality asset like a regional mall, large apartment property or high-rise office building. Due diligence, obtaining the mortgage loan, asset and property management, and leasing and disposition are all left to the sponsor company while investors collect their monthly income."

Adds Bryan, "The TIC structure frees the individual investor from the day-to-day hassles and headaches of sole property ownership, while providing the benefits associated with owning institutional-quality commercial real estate. The often quoted '3 T's' (toilets, tenants, trash) go away as 1031 exchanges defer their capital gain on their sole-owned 'downleg' asset and gain fractional ownership of a truly grand co-owned asset. While there is still risk associated with the investment, it is, in the end, real estate. Of course, these risks are often mitigated by the size and tenancy of these transactions."



Adam Bryan, senior vice president and director of corporate sales of SCI Real Estate Investments.

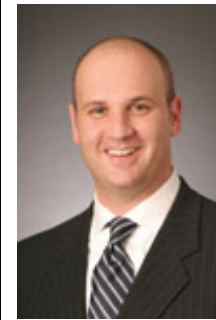
"The key benefit is preserving and maintaining the character of the investment," says Womack. "Your real estate trade remains real estate through the life of the investment, allowing the investor to do another exchange when exiting the investment and thereby protecting the capital gains and deferring the depreciation recapture tax impact."

Adds Goldstein, "The benefits to the TIC structure come

from giving the investor a passive tax advantaged investment with the benefits of being a sole owner of real estate.”

While the TIC structure offers many attractive benefits, there are also significant risks. Many people that jumped on the TIC bandwagon weren't fully aware of the risks involved and are now facing difficulty. The TIC industry has great advantages, but it also has some disadvantages that investors need to be aware of.

“The risks are that it's still real estate,” says Waal. “Too many advisors present this as a guaranteed way to provide income and make money and too many investors think that there won't be any issues with the real estate. All the risks of owning real estate are associated with a TIC. The property that the investor sold didn't have a guaranteed income stream and had issues with it. TICs are typically a higher quality of real estate than what they sold, but that still doesn't eliminate the risks associated with real estate. The key to finding a good TIC property is focusing on the underlying property and the sponsor behind it.”



Marc Goldstein,
president of
Covington Realty
Partners.

“Usually the TIC investor is ‘upgrading’ their investment profile, for example, they may trade out of a small two-unit apartment building into a class A multi-tenant retail building,” says Goldstein. “The risks are both on the sponsor side as well as the real estate side. On the real estate side, the risks are the same as for any real estate investment. Careful underwriting and due diligence is a must.”

Even for those that are knowledgeable about the industry and its risks, there is still an area of concern: exit strategies. TICs are often difficult to get out of due to the multiple investors involved. “Many investors are concerned with exit strategies because they want to know how long their money is going to be tied up,” says Waal. “Each investor has a different objective and they want to know what the business plan is for the property they are going in to.”

Adds Goldstein, “Regarding the concern over exit strategies, I would say it is about 50/50. While this surprises me, many investors are focused on their cash distribution.”

While the ability to get out of a TIC structure will always be a concern, as the industry has matured and proved itself as a viable investment, many investors are not as worried as they once were. “It has declined over time as there have been many successful exits by TIC investors now,” says Womack. “Our firm has long-time investor clients who have made as many as three and four turns through numerous TIC investments.”

Bryan has seen similar situations. “Many TIC-owned deals have gone full-cycle and many of the investors have reinvested in TIC product, further validating the structure for all involved,” he says.

The key to success in the TIC industry is having a thorough understanding of the structure and everything that it entails. Because of its strengths and widespread appeal, the future of the TIC industry looks great. The industry is becoming increasingly popular among baby boomers as a good investment choice for their retirement. “The industry will only have itself to blame if the next 10 years are not great ones,” says Goldstein. “With the demographic of the baby boom generation moving to simplify their lives, the TIC industry should prosper and grow.”

“There is an exciting future ahead for the TIC industry,” says Womack. “We will begin to see some additional property types come into the market as we at Direct Capital are working on some timber assets, as well as pipeline and terminal storage assets, to add to our energy exchange portfolios. As we undergo the ‘graying of America’ demographic transition, you will see additional demand for the TIC as a preferred syndication structure, not just as an exchange structure. This will lead to much broader acceptance and distribution throughout the national financial services marketplace.”

“It's a fairly safe bet that interest rates will continue to rise (for everyone) over the next 6 to 12 months, driving down yields until cap rates adjust,” says Bryan. “Even if real estate values drop overall, and/or we go into a recession, many current property owners have a very low basis and their property has already

seen great appreciation. And, with owners 'getting older every day,' the prospect of completing a 1031 exchange into a highly quality real estate asset will remain appealing."

The TIC industry is expected to stabilize as a higher level of due diligence is being practiced by those involved in the industry. In addition, the segment will also grow as it gains attention among baby boomers as a stable investment vehicle. "The industry will continue to increase its market share as investors become aware of this investment alternative," says Winn. "Sponsor companies offer a variety of property types throughout the United States, as well as risk profiles from value-added to stabilized class A opportunities — something for everyone. The investment returns of TIC properties tend to track with the returns available to other investors and investor structures. The pie may be shrinking, but there is still plenty to go around."

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