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Buying a little piece of a big deal

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Michael Houge and Keith Sturm knew they had a good thing going when they arrived in their office on a number of mornings recently and found a few million dollars in letters of intent for the retail properties they offered over the Internet.

In fact, their Minneapolis-based Upland Net Lease Sales has seen gross volume grow from about $10 million in 1998 to a projected $125 million this year, Houge said.

But they also were certain that an even bigger opportunity waited in a similar market.

Rather than just selling properties for a few million dollars each to single buyers, as they do with Upland, Houge and Sturm have partnered with Minneapolis real estate entrepreneur Duane Lund, managing partner of the Geneva Organization, to also sell properties sliced into portions costing as little as $100,000 each.

The new company, called Safe Harbor Properties Exchange, is projecting first-year, 2004 sales volume of about $100 million to $125 million in so-called tenant-in-common (TIC) deals, and at least double that next year.

"The [Upland] business keeps humming," Houge said, "but in the next year-and-a-half the TIC business will overshadow that. The appetite is so much bigger."

Fractionalized sales of commercial properties have exploded in recent years, a trend that is largely tied to baby boomer business owners looking to sell out and reinvest in a tax-deferred investment vehicle called a 1031 property exchange, and to a clarification of tax law in 2002.

The amount of equity invested in fractionalized commercial real estate, or TICs, has grown from $156 million nationally in 2001 to an estimated $2 billion this year, according to Utah-based Omni Brokerage. Including the loaned portion of the deals, the value of TIC deals is expected to reach $5 billion to $6 billion this year.

Houge said the industry is considerably bigger, though, because Omni counts only TIC deals that are sold through securities brokers.

Lund estimated that the entire 1031 property exchange market is about $50 billion a year and that TICs eventually could capture about 20 percent of that.

The number of firms offering the fractionalized TIC deals also has jumped, from nine in 2001 to more than 35 nationally this year, according to industry estimates. Among the pioneers in the TIC industry is St. Paul-based AEI Capital Corp.

Given the influx of new firms, AEI Executive Vice President Rick Vitale cautioned that some will honor their fiduciary responsibilities, but that others will act simply as "property flippers."

"There are opportunistic groups involved in this industry only because they can be," Vitale said.

TICs usually go hand-in-hand with 1031 property exchanges, which allow investors who've sold commercial properties, whether farms or stores or apartment buildings, to reinvest the proceeds tax-free in other commercial properties.

Investors have 45 days to identify three potential replacement properties and 180 days in total to seal a deal that reinvests all of their proceeds. A third-party intermediary is also required to hold the money in trust until the deal closes.

Those choosing the 1031 route can either buy a whole property -- Upland offers triple-net lease retail properties, which require tenants to take care of everything from maintenance to taxes -- or they can turn to TICs and buy a piece of a bigger property.

Unlike many triple-net properties, which require the buyers to come up with their own financing, TICs are pre-packaged. The investors pay for their share and usually are promised returns of 7 to 10 percent annually, along with benefits such as depreciation and appreciation of the property, without much continuing effort on their part.

H. Thomas Dunck, Midwest regional manager in Chicago for Investment Property Exchange Services Inc., a 1031 intermediary firm, said most people had to actively manage their previous properties and they often are happy to take an easier role with a property exchange.

"Baby Boomers are now getting closer to retirement age and they want to avoid the infamous '3 Ts' -- tenants, toilets and trash," Dunck said. "They want something a little more passive, an armchair type of investment."

The biggest advantages of TICs is that they allow investors with just a few hundred thousand dollars to defer capital gains taxes and get steady returns with a piece of a big, stable property, said Safe Harbor's Houge. Otherwise, they might be forced to buy a bargain-basement property to get the tax break, or maybe just be shut out altogether.

TICs also allow wealthier investors to diversify their holdings in several properties.

Safe Harbor's principals retain equity in each deal in lieu of most fees. "We have skin in the game," Houge said.

Internet sales model

Safe Harbor blends the financial acumen and property procurement skills of Lund with the sales and marketing and Internet knowledge of Houge and Sturm.

Among other positions, Lund was founding shareholder and a senior executive of the New York Stock Exchange-traded real estate investment trust First Industrial Realty Trust, which was involved in $800 million in real estate acquisitions. His Geneva Organization also offers TIC investments outside of Safe Harbor.

Houge and Sturm have been buying and selling Kentucky Fried Chicken, Walgreens, Blockbuster and other retail outlets in the Midwest since the early '90s.

They began to focus on an Internet sales model soon after they started Upland. It offers detailed deal information to time-pressured 1031 investors, who can do everything online up to a letter of intent.

Upland broadcasts about 5,000 e-mails to a network of brokers and investment advisers when it has a new property available. That model is now being applied to Safe Harbor.

Safe Harbor offers several types of real estate, from senior housing to retail complexes to industrial properties and hotels. Investors can mix and match in the fashion of a mutual fund, Lund said.

The variety of offerings is unusual in the TIC market, as is Safe Harbor's focus on selling to brokers rather than securitizing the real estate and selling it through broker-dealers. Even though it is selling its TIC shares as real estate, Safe Harbor makes a point of complying with securities rules. Houge calls it a "belt and suspenders approach."

Wendell Maltby, Midwest regional manager of the California-based intermediary Starker Services Inc., said that while Safe Harbor is relatively new, Geneva and Upland are well-established brands in the Midwest.

Houge said about 25 percent of Safe Harbor's TIC clients are not 1031 exchangers, just investors looking for an alternative to the stock market. He added that the percentage of such clients is growing.

AEI's Vitale emphasized that investors should not let the "tax tail wag the investment dog."

"Everyone loves deferring taxes," Vitale said, "but in any TIC transaction you are engaging in a commercial real estate transaction and you have to make sure you have found real estate consistent with your return objective and your risk tolerance."

Houge said that even in the current go-go TIC market, the goal for Safe Harbor is simply to provide a stable and steady income flow from primarily Midwestern properties.

"We are not doing turnaround deals or swinging for the fences," he said.

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